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Contemporary Economics and Business Association
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TEST SCORES AS MEASURES OF HUMAN CAPITAL AND FORECASTING TOOLS

BARBARA LERNER
Princeton, New Jersey

If we knew what abilities people needed – to develop a modern economy or to maintain one – and could measure those abilities with enough precision to allow for meaningful comparisons between populations, over time and across space, we would have a powerful measure of human capital, and an economic forecasting tool of considerable promise. This essay is an attempt to explore the possibility that we are already in that fortunate position but have not yet seen or exploited our luck because the questions are in one field, and the answers are in another.

Questions about human capital and its impact on the economies of nations are economists' questions, for the most part, and when economists look for measures of human capital, they usually look to traditional measures like "years of schooling completed" or "highest degree received." These measures are linked to the notion of human capital by a set of assumptions: 1) That there is a positive relationship between the abilities needed to run an advanced economy and the things that are taught in schools, and 2) that more time spent sitting in school rooms leads to higher levels of those abilities. These measures are indirect because the abilities themselves are not measured, only other indicators believed to correlate with them. They are also very crude, because the magnitude of the correlation between abilities and indicators is, in each case, an unknown, and an inconstant one at that. Measures with these defects can be and often are seriously misleading but, without more direct and exact measures to compare them with, danger signals may be few and far between. Often, they do not appear at all until long after the optimal time to act – by altering predictions and/or by taking remedial action of some sort – has passed.

Test scores, on the other hand, offer direct measures of a variety of more-or-less specific abilities and, when the tests in question are well-constructed, objective, standardized tests, they are fairly precise measures that can be kept quite constant, over time and across space. Test experts know this; they also know a

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great deal about at least some of the abilities tests measure best but, because they are usually psychologists or educators and not economists, they tend to be preoccupied with their own non-economic questions, questions about why scores change and about the implications of such changes for individual development and for actions and policies intended to foster it. They do not usually know or care much about economists' questions, and are not likely to notice when the abilities they measure directly are the same as those economists measure indirectly. Economists are not likely to notice either, because they are generally unfamiliar with the range and quality of available psychometric data and of its potential utility.

1. Literacy: Two Measures, Two Forecasts

This is easiest to demonstrate by focusing on literacy and using American data to illustrate the point. Literacy is the obvious example here because its economic relevance is so clear. In advanced industrial economies, it is a necessary requirement for most skilled jobs, manual or nonmanual; in post-industrial economies — computerized service-and-information-oriented ones, for example — it may well turn out to be a requirement for all of them, as suggested by the continuing decline in the number of unskilled jobs available in the United States and in other nations with highly developed economies.(1)

Economists are, of course, aware of these facts and have been studying the impact of literacy on economic development for a long time. In the United States, they usually rely on Census Reports for this purpose because they offer the most complete data available on the American population as a whole, and because they have a wonderful historical sweep — the U.S. Census Bureau has been counting American noses since 1789 and has reported rates of illiteracy in the population since 1870. Initially, they simply asked people if they could read and write or not, and recorded their answers. In 1947, they limited the scope of their inquires by assuming that people with 5 or more years of schooling were, ipso facto, literate; in 1952 they decided that 6 or more years of schooling completed was a safer benchmark for literacy and that, along with self-

(1) U.S. Census Bureau, *Historical Statistics of the United States, Colonial Times to 1970,* Part 1, p. 139 (Washington, D.C.: U.S. Government Printing Office, 1975).

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report data on Americans with fewer than 6 years of schooling, has continued to be the criterion, up to the present day.(2)

Using these criteria, the Census Bureau reported that the rate of illiteracy among Americans over the ages of 14 or 15 years was 11.3% at the turn of the century, and declined to 1.2% by 1970.(3) Among Americans aged 14 to 24, the rates reported were lower still, amounting to a mere .6% in 1959 and falling to .2% in 1979.(4) More encouraging still, the long-standing educational gap between white and black Americans seemed to be closing at last, at least in the emerging generation. In 1959, the illiteracy rate for black Americans aged 14 to 24 was only 1.2%, but it was still more than double the white rate; by 1979, the rates were the same for both groups — .2%, according to the Census measures.(5)

On this basis, it would have seemed reasonable — at least to a post hoc noneconomist — to make a number of optimistic forecasts for the U.S. economy in the 1980s, e.g., no shortage of literate workers, no serious structural unemployment problems, and a quick end to the potentially disruptive consequences of black-white disparities in employment and income. Thus far, none of those happy forecasts have been borne out, and familiarity with the results of studies using psychometric measures of the same variable — literacy — suggested that they were not likely to be. Familiarity with these results was not, however, widespread, even among psychometricians, let alone among economists, due, primarily, to the fragmentation of the social sciences and the mutual oblivion that it breeds.

Mutual oblivion and fragmentation nothwithstanding, psychometricians also measured literacy, but only in recent times, and only very intermittently at that, and they added to the confusion by using different tests with different populations at different points in time, each with a somewhat different definition of literacy.(6) The result is a confusing farrago of

(2) Ibid., pp. 364-365.
(3) U.S. Census Bureau, *Statistical Abstract of the United States, 1981,* p. 143.
(4) Ibid., p. 143.
(5) Ibid., p. 143.
(6) Louis Harris & Associates, *Survival Literacy Study,* No. 2036, National Reading Council, September, 1970; Louis Harris and Associates, *The 1971 National Reading Difficulty Index,* New York, 1971 ERIC ED 057 312; Richard T. Murphy, *Adult Functional Reading Study,* Washington, D.C.: National Institute of Education, 1973; N. Northcutt, *Adult Functional Competency: A Summary* (Austin, Texas:

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one-shot studies which at first glance seem much less promising than census data. In fact, their potential utility is much greater.

The great strength of these studies is that they contain no built-in assumptions about the relationship between literacy and years of schooling completed or any other variable, for that matter, and they are not subject to the obvious vagaries of self-report data. Psychometricians may not measure literacy often, but they do not need to rely on assumptions when they do, because they measure it directly. They ask people to *demonstrate* their comprehension of simple, written questions by responding appropriately to a fixed number of them in a delimited period of time under controlled conditions.

In 1970, 1971, and 1975, researchers from the National Assessment of Educational Progress (NAEP) did this, using only easy, everyday questions of the sort that are ubiquitous to everyday life and work in a society with an advanced economy.(7) They found that in 1975, the best of the three years studied, 12.6% of all American 17 year olds still enrolled in school were functionally illiterate, unable to respond correctly to even 75% of these easy, everyday items; 44.4% were semi-literate, missing more than 10% but less than 25%. Worst yet, these figures are gross underestimates of the actual extent of illiteracy among American teenagers in the 1970s, because students who dropped out of school at age 16 – approximately 20 to 25% of the total youth population in the last decade or so – were excluded from the NAEP samples. When the necessary additional data on these students are factored in, the over-all rate of illiteracy for cohorts reaching their eighteenth birthday in the 1970s can safely be estimated to have been at least 20%; the semi-literacy rate was probably closer to 60%.(8) And the

University of Texas, March, 1975). *See also* Abraham Carp, "The Reading Problem in the United States," 17, 36-45, in Reginald Corder, *The Information Base for Reading: A Critical View of the Information Base for Current Assumptions Regarding the Status of Instruction and Achievement in Reading in the United States,* Washington, D.C.: Office of Education, 1971; T.G. Sticht, J.S. Caylor, R.P. Kern, and L.C. Fox, "Project REALISTIC: Determination of Adult Functional Literacy Levels," *Reading Research Quarterly,* Vol. 7, 1972, pp. 424-465; Rose-Marie Weber, "Adult Illiteracy in the U.S.," in John B. Carroll & Jeanne Chall (Eds.), *Toward a Literate Society* (New York: McGraw-Hill, 1975).

(7) National Assessment of Educational Progress, *Functional Literacy: Basic Reading Performance* (Denver, Colorado: NAEP, 1976).

(8) Barbara Lerner, *Minimum Competence, Maximum Choice: Second Chance Legislation,* pp. 86-89 (New York: Irvington, 1980a); Barbara Lerner, "The Minimum

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black-white gap was still dramatic: 41.6% of all black 17 year olds still enrolled in school in 1975 were functionally illiterate; 82.7% were semi-literate.(9)

On this basis, it would have seemed reasonable to predict serious shortages of literate workers throughout the 1980s and perhaps beyond, along with high levels of structural unemployment, particularly among younger black workers, and increasing difficulty in meeting economic competition from foreign countries with more literate work forces.

2. Higher Abilities: Traditional Measures v. Economic Realities

With regard to questions of international economic competition, it seems clear that human capital alone does not determine outcome. It seems equally clear that it has an impact on it, an impact that cannot be adequately assessed simply by counting – however accurately – the size of each country's literate work force. Something beyond mere literacy – some higher level of knowledge and/or developed abilities, is obviously important too, and must somehow be assessed, if we are to make reasonable comparisons between nations, and reasonable predictions and recommendations based on them.

The Assessment of these higher level abilities is far more difficult than the assessment of literacy because we are much less clear about what they are and because we must, nonetheless, employ a higher level of measurement in assessing them if we are to produce results that have some practical utility. Literacy is not only easier to define, it is also easier to measure because it is a minimum standard, a threshold requirement. There is room for a narrow range of disagreement about exactly where the threshold is, but the basic question posed – how many workers in a country are literate, how many not – is a nominal one, so a simple nominal measure suffices. All that is required is a device that allows us to sort data into two categories, and to count the numbers in each.

Questions about higher abilities, on the other hand, are questions about relative standards, questions about "how much" as

Competence Testing Movement," *American Psychologist,* pp. 1058-1059, Vol. 36, October, 1981a, 1057-1066; Barbara Lerner, "Vouchers for Literacy: Second Chance Legislation," *Phi Delta Kappan,* December, 1981b, 252-255.

(9) Lerner, 1980a, op. cit. at p. 88.

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well as about "how many," and there is no fixed reference point for "how much." How much is enough varies; in economic terms, it is a function of the competition that a nation must meet to succeed in a particular market at a particular point in time. To answer questions of that sort, ordinal or equal interval measures are required, measures that allow us to rank order nations according to the respective levels of knowledge and developed abilities attained by their work force, or segments of it, at particular points in time.

When economists try to do this, they generally rely, once again, on the traditional measures of human capital, "years of schooling completed" and/or "diplomas received." This approach does not solve the underlying definitional question — which sorts of higher abilities are important to economic success, which are not — but it does allow us to sidestep the problem by assuming that whatever those unnamed abilities are, they correlate with higher education in a straight forward linear way.

Comparisons between countries based on these assumptions indicate that the United States is far ahead of all potential competitors.(10) In the last two decades, we sent more of our young people to school for longer periods of time than any other nation in the world,(11) and they emerged with more diplomas than any other people on earth. The expansion of education in this country in those two decades was striking, particularly at the college and university level. At the high school level, the great expansion took place earlier, and over a longer period of time. In 1900, less than 10% of all American 18 year olds were high school graduates;(12) in 1950, 56% were. By 1960, that figure had risen to 72.4%, and the percentages remained above the seventy percent mark throughout that decade and the next one, while the actual number of graduates swelled from 1,200,000 in 1950 to more than 3 million by 1980.(13) At the college and university level, enroll-

(10) Barbara Lerner, "American Education: How Are We Doing?" *The Public Interest,* Vol. 69, Fall, 1982, pp. 59-82.

(11) Robert M. Bjork and Stewart E. Fraser, *Population, Education and Children's Futures* (Bloomington, Indiana: Phi Delta Kappa, 1980); Ruth L. Sivard, *World Military and Social Expenditures 1978* (Leesburg, Virginia: WMSE Publications, 1978); U.S. Census, 1981, op. cit., pp. 873-874.

(12) U.S. Census, *Historical Statistics,* op. cit., p. 379.

(13) U.S. Census, 1981, op. cit., p. 157.

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ment jumps in the last two decades were manifest in proportional terms as well as in absolute numbers. In 1960, almost a quarter of all U.S. high school graduates between the ages of 18 and 24 were enrolled in college; in 1970, almost a third of them were, and that was true in 1980, too.(14) Freshman enrollment figures were even higher. Throughout the 1970s, approximately half of the members of each American high school graduation group – about a million and a half students a year – went to college.(15)

Available data indicate that no other nation had a comparable educational record, across the board. Towards the end of the twenty year period in question Japan, Russia and Sweden rivalled the United States in the percentages of students graduating from secondary schools but not in the percentages going on to college.(16) Sweden aside, the percentages of secondary school graduates in most western European nations were much lower than they were in America, ranging from 20% to 50% in countries like England, France, Belgium, and Ireland.(17) Percentages in other western European nations were even lower, and more comparable to those in underdeveloped nations. In West Germany, the Netherlands, and Italy, they were below 20%; that was also the case in Iran, Thailand, India, and Chile.(18)

The contrast between the United States and the rest of the world with respect to college admission rates was even greater. No other western nation sent nearly as high a proportion of its secondary graduates on to college; neither did any Communist nation. Until very recently, the Soviet Union seemed to be graduating only about two-thirds of its secondary school students and sending only about 10% of them on to the institutions of higher learning.(19) Work by University of Chicago

(14) Ibid., p. 158.

(15) *See,* e.g., the annual reports issued by the College Entrance Examination Board from 1972 through 1979 under the title *National College Bound Seniors* (New York: CEEB, 1972-79).

(16) Lerner, 1982, op. cit.

(17) Judith V. Torney, A.N. Oppenheim, & Russell F. Farnen, *Civic Education in Ten Countries: An Empirical Study* (New York: Wiley, 1975); Ralph W. Tyler, "The U.S. vs. the World: A Comparison of Educational Performance, *Phi Delta Kappan,* 1981, 62, 307-310; Richard M. Wolf, *Achievement in America: National Report of the United States for the International Educational Achievement Project* (New York: Teachers College Press, 1977).

(18) Ibid.

(19) Nigel Grant, *Soviet Education,* 4th ed. (New York: Penguin Books, 1979);

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mathematician Izaak Wirszup indicates that in the last few years, the Soviet's secondary school graduation rate rose dramatically but there was no comparable increase in the number of Soviet students who go on to college, currently estimated at about one million a year.(20) China, insofar as available data enable us to judge, seems to be graduating less than 20% of her secondary students and to be allowing only about 5% of these – less than 1% of the entire age group – to enter institutions of higher learning. Thus, of some 6 million students who took the newly reinstituted college entrance exam in China in 1978, only about 290,000 were selected for post-secondary education, a selection ratio of about 20 to 1.(21)

Using the same measures – years of schooling completed and/or degrees received – American teachers seem as superior as American students. In the mid-sixties, about 15% of the elementary school teachers and about 30% of the high school teachers in this country held masters or doctors degrees; by 1980, those figures had risen to about 40% and 50%, respectively.(22) Comparisons made by the International Association for the Evaluation of Educational Achievement (IEA) in the 1960s and 70s indicate that no other nation had school teachers with that many years of post-secondary education.(23)

On this basis, it would have seemed reasonable to anticipate high and rising work force productivity in the United States, and great success in meeting foreign competition in economic endeavours, in which large pools of workers and managers with highly developed abilities are a decided asset. In fact, the opposite seems to have happened: American productivity declined sharply, particularly in the 1970s, and American firms experienced increasing difficulty in maintaining their former

Delbert & Roberta Long, *Education in the USSR* (Bloomington, Indiana: Phi Delta Kappa, 1980); Hedrick Smith, *The Russians* (New York: Ballantine Books, 1977) p. 254.

(20) Izaak Wirszup, "The Soviet Challenge," *Educational Leadership,* February 1981.

(21) Robert D. Barendsen, *The 1978 National College Entrance Examination in the People's Republic of China* (Washington, D.C.: U.S. Office of Education, 1979); Fox Butterfield, *China: Alive in the Bitter Sea* (New York: Times Books, 1982), p. 197; Ronald Dore, *The Diploma Disease* (Berkeley: University of California Press, 1976), p. 171.

(22) U.S. Census 1981, op. cit., p. 151.

(23) A. Harry Passow, Harold J. Noah, Max A. Epstein, and John R. Mallea, *The National Case Study: An Empirical Comparative Study of Twenty-one Educational Systems* (New York: John Wiley & Sons, 1976); Torney et al, op. cit., p. 71.

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shares of the market, at home and abroad, in a variety of areas where human capital seems to play an important role. In many of those areas, Japanese firms made striking gains, but Swedish firms did not, and countries like West Germany with much smaller proportions of highly schooled workers and managers did not seem unduly handicapped in competition with either the Swedes or the Americans.

3. Test Scores, Occupational Competence, and Productivity

During this same period, predictions made on the basis of test scores would have been very different, particularly in the American case, but few such predictions were made. Here, the problem was not so much a lack of familiarity on the part of economists and others with test results over time; the failure was one of connectedness. Almost all regular readers of the American press are aware that scores on one of the best known standardized tests in routine use in this country – the Scholastic Aptitude Test (SAT) – began to decline in 1964 and continued to do so at a generally accelerating rate for the next 16 years, through 1980.(24) The problem was that few readers had any clear notion of what economic relevance, if any, that had. The economic relevance of literacy seems clear; the economic relevance of the abilities measured by the SAT and a host of similar tests – developed verbal and mathematical reasoning abilities – seems much more obscure, not only to economists but to many psychometricians as well.

Psychometricians are divided by subject matter specialty areas into two main groups, one focusing on educational questions, the other on questions of industrial and organizational psychology. When it comes to methodology, there is much common ground between the two groups; when it comes to substantive ideas, relatively little.

The psychometricians who developed the SAT were educators and educational psychologists, and the concerns of industrial psychologists, were, in many ways, as foreign to them as those of economists. Their exclusive aim, from about 1900 on, was to devise a test that would be useful in predicting a high school

(24) College Board, *On Further Examination: Report of the Advisory Panel on the SAT Score Decline* (New York: College Entrance Examination Board, 1977); College Board, op. cit., 1978, 1979, and 1980.

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student's chances for success in college, irrespective of the exact nature of the substantive curriculum in the particular high school he or she had attended.(25) The result of their efforts, the SAT, was first introduced in 1926, and it has been in continuous use ever since, with samples of students that have grown progressively larger over the years. In recent decades, the number of American students taking it each year has ranged from about a million to a million and a half.

From the beginning, the SAT did the job it was intended to do quite well: correlations between high school SAT scores and first year college grades have been consistently significant over the years, no matter what sort of backgrounds the test-takers came from or which academic fields they entered. The usual correlations were and are moderate, not high, but they are, nonetheless, impressive, especially in light of the fact that, until very recently, most schools using the SAT had highly selective admissions policies. Students with low scores were usually denied admission altogether, narrowing the range of scores in the accepted group quite sharply, and making it much harder to get high correlations, even with very large samples, than it is with unselected samples exhibiting the full range of possible scores.(26)

Scholastic predictive power notwithstanding, the link between the abilities measured by the SAT and those required for occupational competence and economic productivity seems, at first glance, to be much weaker. Many educational specialists are unaware that it exists at all, and assume that the abilities needed in the occupational sphere are quite distinct from those needed in the academic one. In fact, however, there is a large and growing mass of empirical evidence indicating that developed verbal and mathematical reasoning abilities are as important in the occupational sphere as they are in the educational one, and that tests of these abilities have comparable predictive power in both spheres. This comparability extends to breadth as well as to height: the predictive power of these tests crosscuts the lines between different jobs as easily as it crosscuts those between different academic fields.

The evidence on this question is derived from a very large

(25) Barbara Lerner, "The War on Testing: David, Goliath, and Gallup." *The Public Interest,* Vol. 60, Summer, 1980b, pp. 126-127.

(26) Ibid., p. 137.

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number of studies by industrial psychologists over a period of more than 50 years but, because most of these studies were based on very small samples, their overall import was not clearly perceived, even by industrial psychologists, until quite recently. Results from studies with small samples can be and often are seriously misleading – as misleading, in fact, as those from studies using crude and inaccurate measures. Accurate measures are essential, as illustrated by the example of literacy, but they are not enough. Adequate samples are also necessary for a clear picture of reality to emerge. Studies in industrial psychology often met the first criterion; they seldom met the second.

As a result, industrial psychologists found what looked, to many of them in the 1960s and early 1970s, like an endless array of situation-specific vocational requirements.(27) No single test or group of tests seemed capable of predicting the performance of workers or managers in different lines of work. Worse yet, no single test or group of tests seemed capable of predicting performance in different industrial settings, even when the job titles and descriptions involved were virtually identical. Generality seemed nonexistent; specificity all pervasive.

Methodological developments in the second half of the last decade brought this chaotic picture into sharp and sudden focus. New meta-analytic techniques developed more or less simultaneously by separate groups of educational and industrial psychologists in the late 1970s allowed psychometricians to aggregate data across hundreds of separate small sample studies creating combined sample sizes in the thousands and hundreds of thousands, correcting for the severe deficiencies in sample size that had plagued their work in the past,(28) and in some

(27) L.E. Albright, J.R. Glennon, and W.J. Smith, *The Use of Psychological Tests in Industry* (Cleveland: Howard Allen, 1963), p. 18; E.E. Ghiselli, *The Validity of Occupational Aptitude Tests* (New York: Wiley, 1966), p. 28; Robert M. Guion, *Personnel Testing* (New York: McGraw Hill, 1965), p. 126.

(28) Gene V. Glass, "Primary, Secondary, and Meta-analysis of Research," *Educational Researcher,* 1976, 5, 3-8. Gene V. Glass, "Integrating Findings: The Meta-analysis of Research," *Review of Research in Education,* 1977, 5, 351-379; Gene V. Glass, G. McGaw, and M.L. Smith, *Meta-analysis in Social Research* (Beverly Hills, Calif.: Sage Publications, 1981); John E. Hunter, Frank L. Schmidt, and Gregg B. Jackson, *Meta-analysis: Cumulating Research Findings Across Studies* (Beverly Hills, Calif.: Sage Publications, 1982); Frank L. Schmidt and John E. Hunter, "Development of a General Solution to the Problem of Validity Generalization," *Journal of Applied Psychology,* 1977, 62, 529-540.

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cases, making useful corrections for restriction of range and criterion unreliability as well. When these procedures were followed, the apparent variability in results achieved with tests of the predictive power of the same abilities in different situations was revealed to be largely artifactual.

The most impressive large scale research program along these lines was that carried out by Frank Schmidt, John Hunter, and their colleagues. Their pioneering work in the development and application of meta-analytic techniques to the problems of industrial psychology provided us with a series of convincing demonstrations of the fact that tests of verbal and mathematical reasoning ability are at least as powerful in the occupational sphere as they are in the educational arena. These SAT-like tests predict worker competence and productivity in a very wide array of occupations at a very wide range of levels and across a very wide variety of settings.

The Schmidt-Hunter group began their work with statistical analyses demonstrating that the sample sizes needed to produce adequate power in typical empirical validation situations were in the 100 to 1,000 range – much larger than most industrial psychologists had assumed, particularly in private sector research where typical American sample sizes were closer to 40 than to 100 or 1,000.(29) In statistical terms, that fact alone could account for most of the variability in test results from one job setting to another. Relationships between test scores and measures of occupational competence and productivity that show up with great clarity and consistency in samples of 100 to 1,000 would, predictably, be obscured by chance variations in smaller samples, and at predictable frequencies. Examining the literature on situation specificity with this analysis in mind, the Schmidt-Hunter group found that the predicted frequencies of these chance variations were very close to the actual frequencies found in small sample research. Building on this foundation, they emerged with a general solution to the problem of validity generalization(30) and with

(29) Frank L. Schmidt, John E. Hunter, and Vern W. Urry, "Statistical Power in Criterion-Related Validation Studies," *Journal of Applied Psychology,* 1976, 61, 473-485; Frank L. Schmidt and John E. Hunter, "Moderator Research and the Law of Small Numbers," *Personnel Psychology,* 1978, 31, 215-231.

(30) Frank L. Schmidt and John E. Hunter, "Development of a General Solution to the Problem of Validity Generalization," *Journal of Applied Psychology,* 1977, 62, 529-540.

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the methodology necessary to test it out by compiling and aggregating data from a multiplicity of small sample studies.(31)

On a more concrete level, they began by focusing on a single job – computer programming – and examining the ability of a particular test – the Programmer Aptitude Test (PAT) – to predict the later competence and productivity of entry-level computer programmers in a variety of different job settings, in the federal government which employed almost 20,000 of them in 1976, and in the U.S. economy as a whole which employed more than 150,000 of them in 1970.(32) The PAT is not as well known as the SAT but it, too, measures mathematical reasoning ability, and it was found to have substantial and generalizable validity in selecting superior performing computer programmers in all work settings studied. The relationship between test scores and occupational competence in this line of work proved to be substantially linear, whether the criterion of competence was success in meeting training program standards or on-the-job performance, and the differences in output between high and low scoring programmers were quite substantial, especially at the extremes. Supervisors estimated the difference in dollar value of output between programmers at the 85th and 50th percentiles at about $10,000 per programmer per year, and the same was true for the difference between programmers at the 50th and 15th percentiles. Extrapolating from these figures, the estimated productivity gains that would have been derived from using the PAT to select all computer programmers would be more than a billion dollars for the federal government alone, more than 10 billion dollars for the U.S. economy as a whole.

Next, the Schmidt-Hunter group focused on clerical work as defined by the U.S. Labor Department's Dictionary of Occupational Titles (DOT)(33) – a large family of different jobs which includes production and stock clerks and computing and account recording clerks as well as the usual typists, stenogra-

(31) See sources cited at n. 28 supra.

(32) Frank L. Schmidt, John E. Hunter, R.C. McKenzie and Tessie W. Muldrow, "The impact of valid selection procedures on work force productivity," *Journal of Applied Psychology,* 1979, 64, 609-626; Frank L. Schmidt, I. Gast-Rosenberg, and John E. Hunter, "Validity Generalization Results for Computer Programmers," *Journal of Applied Psychology,* 1980, 65, 635-642.

(33) U.S. Department of Labor, *Dictionary of Occupational Titles* (4th ed.) (Washington, D.C.: U.S. Government Printing Office, 1977).

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phers, and file clerks, among others. A thorough literature search revealed 698 previous psychometric studies relevant to these jobs, studies with a total combined sample size of more than 350,000. These studies had used a variety of different tests, measuring a variety of different abilities. Schmidt and Hunter used meta-analytic techniques to analyze them all, and found that for most clerical jobs, the best predictors of occupational competence were tests of verbal and mathematical reasoning abilities, in combination with tests of perceptual speed and accuracy, and concluded "[r]esults strongly suggested that validities were the same for all clerical occupations despite differences in task make-up among the different areas of clerical work."(34)

Having found powerful evidence for validity generalization for the same job in different settings, and for different jobs in the same job family, the Schmidt-Hunter group then looked at available data on the power of tests of the same abilities to predict competence at different jobs in different job families.(35) For this purpose, they focused on two employment tests that have been used with maximally diverse populations of workers over extended periods of time: the GATB (General Aptitude Test Battery) and the ACB (Army Classification Battery). Sample size is rarely a problem with the ACB or its successor, ASVAB, because the employer who uses them is a very large employer indeed — the U.S. military.(36) It was a problem with the GATB but meta-analytic techniques obviated that problem. Both tests measure developed verbal and mathematical reasoning abilities, as well as some other cognitive attributes, and both are routinely used with workers representing the entire range of occupations in the purview of the testing agency. In case of the GATB, the testing agency is the U.S. Labor

(34) Kenneth Pearlman, Frank L. Schmidt, and John E. Hunter, "Validity Generalization Results for Tests Used to Predict Training Success and Job Proficiency in Clerical Occupations," *Journal of Applied Psychology,* 1980, 65, 373-406.

(35) John E. Hunter, "Validity Generalization for 12,000 Jobs: An Application of Synthetic Validity and Validity Generalization to the General Aptitude Test Battery," U.S. Employment Service, U.S. Department of Labor, Washington D.C. 1980; John E. Hunter, "Validity Generalization and Construct Validity," in *Construct Validity and Psychological Measurement,* Princeton, N.J.: Educational Testing Service, 1980; Frank L. Schmidt, John E. Hunter, and Kenneth Pearlman, "Task Differences in the Validity of Aptitude Tests in Selection: A Red Herring," *Journal of Applied Psychology,* 1981, 66, 166-185.

(36) Lerner, 1980b, op. cit. at p. 125.

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Department and its purview is the civilian economy as a whole. The ACB was a U.S. Army classification test, used to help assign soldiers to military jobs as diverse as those of cooks, welders, clerks, radar repairers, personnel administrators and small weapons mechanics.

Massive data from both tests indicate that verbal and mathematical ability scores allow us to predict the occupational competence of workers in all jobs studied, military and civilian, at a level well beyond chance. The number of jobs studied was very large: in the army study, 35 different jobs were involved; in the Labor Department study, 500 different jobs. As might be expected, the correlations between verbal and mathematical reasoning abilities and occupational competence were highest for managerial and professional jobs, lowest for semi-skilled and unskilled ones, but even in the latter case, they were still high enough to have practical impact. For skilled workers, white collar or blue, the correlations were highest for jobs like repairman in which problem-solving is an essential element; lowest for jobs like dental hygienist in which routine procedures are routinely followed.

These results surprised many psychometricians, but should not have. The data on ACB scores and occupational competence reported by Schmidt and Hunter were collected when those two researchers were still schoolboys. It comes from a 1957 military study with sample sizes so large that no newly developed methodological refinements were needed to uncover its essential implications.(37) Similar samples are the rule rather than the exception for military testing and have been throughout its history, a history that extends back in time to World War I. Similar results are the rule, too. Here, for example, is the testimony of a distinguished veteran psychometrician, Professor Lloyd G. Humphreys of the University of Illinois, summarizing his experiences, first as a member of the U.S. Air Force's Aviation Psychology Program in the 1940s and then as a civilian director of the Air Force Research Unit in the 1950s:

> In summary, therefore, the primary problem was finding stable differential validities for the tests we were administering. Establishing validity generalization [for tests of

(37) W.E. Helm, W.A. Gibson, and H.E. Brogden, "An Empirical Test of Shrinkage Problems in Personnel Classification Research," Adjunct General's Office, Personnel Research Board Technical Research Report, Note 84, October, 1957.

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verbal and mathematical reasoning abilities] was no problem; it could not be avoided.(38)

4. Test Scores and Economic Realities Across Space

The evidence summarized above indicates that scores on standardized tests of verbal and mathematical reasoning abilities relate to economic competence and productivity in meaningful ways. As such, they provide a potentially useful alternative to traditional measures of economically relevant higher abilities like "years of schooling completed," or "diplomas received." They provide an alternative picture of the development of human capital in the world in the 1960s and 70s too, a picture that is sharply at odds with the one painted by traditional measures, but one that seems much more compatible with emerging economic realities.

This alternative picture is still very incomplete, because instances when representative samples of populations from different nations take the same tests are still relatively rare, especially in vocational as opposed to academic settings. As a result, there are little or no useful comparative test data on the scores of workers in different nations, or, at any rate, little or none in the public domain. Cross-national coverage is better for student samples, but even in this area, large gaps remain. We have, for example, no useful comparative data at all on the scores of Russian or Chinese students, and that is true for students from most developing nations as well.

We do, however, have some data on the scores of students in at least two eastern bloc countries – Hungary and Rumania – and on students in at least four developing countries – Chile, India, Iran, and Thailand. The data base for developed nations in the noncommunist world is much more complete: we have some good initial comparative data on students from the United States, Japan, and Sweden, and from most other western European nations as well, including England, Scotland, Ireland, France, West Germany, Italy, Belgium, and the Netherlands.

These data were collected by an international group of educators and educational psychologists working first in connection with UNESCO and later under the auspices of the IEA

(38) Lloyd G. Humphreys, Unpublished Memorandum on Validity Generalization, University of Illinois in Urbana, 1982.

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– the International Association for the Evaluation of Educational Achievement. Beginning in the late 1950s, these researchers worked together to develop a battery of international tests, many available in as many as 14 different languages. In the late 1960s and the early 1970s, varying parts of this test battery were administered to reasonably large, representative samples of students from a total of 21 countries – more than a quarter of a million students in all.(39) We also have interesting additional data specific to comparisons between students from the United States and Puerto Rico, derived from an equating study of the Prueba de Aptitud Academica – the Spanish-language version of the SAT.(40)

The SAT is, of course, a direct test of developed verbal and mathematical reasoning abilities, as were three of the eight tests developed by the IEA. The other five IEA tests covered substantive knowledge in a variety of specific content areas – science, literature, civics, and two "foreign" languages, French and English. Tests of the latter type are generally referred to as

(39) For useful overviews, analyses, and critiques of the IEA studies, *see* Lerner, 1982, op. cit.; Alex Inkeles, "The International Evaluation of Educational Achievement: A Review," *Proceedings of the National Academy of Education,* Vol. 4, 1977, pp. 139-200; Alan C. Purves and Daniel U. Levine, *Educational Policy and International Assessment: Implications of the IEA Surveys of Achievement* (Berkeley, California: McCutchan, 1975).

For the IEA's own reports on the data collected, *see* John B. Carroll, *The Teaching of French as a Foreign Language in Eight Countries* (New York: Wiley, 1975); L.C. Comber and John P. Keeves, *Science Education in Nineteen Countries: An Empirical Study* (New York: Wiley, 1973); Torsten Husen (Ed), *International Study of Achievement in Mathematics: A Comparison of Twelve Countries,* Vols. I and II (New York: Wiley, 1967); E. Glyn Lewis and Carolyn E. Massad, *The Teaching of English as a Foreign Language in Ten Countries* (New York: Wiley, 1975); A Harry Passow, Harold J. Noah, Max A. Eckstein, and John R. Mallea, *The National Case Study: An Empirical Comparative Study of Twenty-One Educational Systems* (New York: Wiley, 1976); Gilbert F. Peaker, *An Empirical Study of Education in Twenty-one Countries: A Technical Report* (New York: Wiley, 1975); Alan C. Purves, *Literature Education in Ten Countries: An Empirical Study* (New York: Wiley, 1973); Robert L. Thorndike, *Reading Comprehension Education in Fifteen Countries: An Empirical Study* (New York: Wiley, 1973); Judith V. Torney, A.N. Oppenheim, and Russell F. Farnen, *Civic Education in Ten Countries: An Empirical Study* (New York: Wiley, 1975); and David A. Walker, *The IEA Six-Subject Survey: An Empirical Study of Education in Twenty-one Countries* (New York: Wiley, 1976).

See also Richard D. Noonan, *School Resources, Social Class, and Student Achievement* (New York: Wiley, 1976).

(40) William H. Angoff and Christopher C. Modu, Equating the Scales of the Spanish-Language Prueba de Aptitud Academica and the English-language Scholastic Aptitude Test of the College Entrance Examination Board (New York: CEEB Research and Development Report 72-73, No. 4, January 1973).

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knowledge or achievement tests, and previous research on the relationship between tests of that type and tests of verbal and mathematical reasoning abilities indicates that correlations between the two are generally high, making it reasonable to combine data on both types of test in making a rough initial assessment of the relative levels of human capital development in different countries during the last two decades.

Combined data from these sources strongly suggest that it was Japan and not the United States that led the world in the development of human capital in the late 1960s and in the early 1970s. In the IEA studies, Japanese students participated in tests of mathematical reasoning ability and in tests of knowledge in the physical and biological sciences, and their mean scores were dramatically higher than those of American students on both types of test. Japanese students' mean scores on these tests also surpassed those of students from most western European nations most of the time.

Students from western European nations also surpassed students from the United States, not all of the time as in the case of Japan, but most of the time and, in general, the older the students, the greater the gap. Even Swedish students, who ranked in the bottom half of the western European distribution more often than not, surpassed American students on most tests at most age and grade levels. Hungarian and Rumanian students, on the other hand, generally seemed to do about as well as students from western European nations and, in at least one instance, markedly better.

The only student group whose test score means were usually lower than those of American students in the 1960s and 70s were those from underdeveloped nations. On the IEA tests, students from those nations generally had mean scores that were about two standard deviations below those of students from developed nations. In contrast, the usual maximum gap between the test score means of students from different developed nations was only half as large – about one standard deviation. (41)

(41) *See* Lerner, 1982, op. cit. at p. 64. *See also* Benjamin S. Bloom, "Implications of the IEA Studies for Curriculum and Instruction" at p. 68 in Purves and Levine, op. cit.

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5. Test Scores and Economic Realities Over Time

The gross, immediate economic predictions one would make on the basis of the over-all international test score pattern presented above seem clear. Japan would be expected to lead the world in economic growth, at least, to the extent that economic growth is dependent on the development of human capital. In this rank order, Europe would be second, followed by the United States, and then the less developed nations. The fit between these predictions and the economic realities of the last decade or so seems reasonably close, especially when compared to the predictions suggested by the traditional measures of human capital at this level.

Those traditional measures – years of schooling completed and/or degrees received – did not reflect the full magnitude of Japanese progress in the development of human capital in the post World War II years, and they did not reflect America's backward movement at all. Test scores did, showing large gains in Japan,(42) and even larger losses in the United States.(43)

This gross difference in the sensitivity of the two types of measures is not as surprising as it may at first appear. Scores on well-constructed standardized tests have a great advantage over the traditional measures of human capital when it comes to detecting and measuring changes over time. They allow us to measure them with a high degree of accuracy because they allow us to maintain a relatively constant standard over time, and to detect and measure any shifts in standards that do occur.

Thus, in the American case, research on scale drift with the SAT shows that efforts to hold the difficulty level of the test constant over the years were quite successful from 1941 to 1963.(44) Efforts were somewhat less successful from 1963 to 1973, when some downward drift occurred, making it a bit easier to get higher scores after 1963 than before.(45) The SAT

(42) Richard Lynn, "I.Q. in Japan and the United States Shows a Growing Disparity," *Nature,* Vol. 297, pp. 222-223, May, 1982; Lester Tarnopol and Muriel Tarnopol, "Arithmetic Ability in Chinese and Japanese Children," *Focus on Learning Problems in Mathematics,* Vol. 2, pp. 29-48, July, 1980.

(43) Lerner, 1982, op. cit.

(44) E.E. Stewart, The Stability of the SAT-Verbal Score Scale, College Entrance Examination Board Research and Development Report 667, No. 3 (Princeton, N.J.: Educational Testing Service, 1966).

(45) Christopher C. Modu and June Stern, The Stability of the SAT-Verbal Score Scale, Report for the Advisoty Panel on the SAT Score Decline (New York: College Entrance Examination Board, 1977).

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was also easier to read in the 1960s and 70s than it was in the 1940s and 50s: the difficulty level of reading passages on the test declined, as measured by the Dale-Chall formula, from a corrected grade level of 13-15 to one of only 11-12.(46) All in all, SAT scores in recent decades probably underestimate the actual American score decline by about 8 to 12 points.(47)

These minor shifts in constancy of measurement might have obscured a minor negative change in the level of development of the verbal and mathematical reasoning abilities of American students, but they did not obscure the major negative change that took place here in the 1960s and 70s the way traditional measures did. Traditional measures indicated that American competence levels were going up. Scale drift notwithstanding, SAT data indicated that the mean scores of American students declined by some 90 points from 1963 to 1980,(48) a drop that is in the neighborhood of one half of a standard deviation. All in all, test scores seem to have a better track record as measures of human capital and as predictors of economic growth and development. Still, all this is post hoc prediction, an art with limited validity and utility.

Let us now examine American test score patterns over time in more detail, in an effort to see the past more clearly, and to tease out some initial a priore predictions. For this purpose, we shall focus mainly on the SAT, because it is one of the few good tests in common use in this country for which we have sufficiently detailed data on year-to-year changes in mean scores over a long enough period of time to make a detailed examination of patterns of temporal change feasible.

The SAT, as noted in section 3, has been in continuous, annual use with samples of American high school students who plan to go on to colleges, particularly eastern ones, since 1926 but, unfortunately, the owner of the test, the College Entrance Examination Board, has seen fit to release annual mean scores only from 1952 onwards. Still, that leaves us with data on year-

(46) Jeanne S. Chall, An Analysis of Textbooks in Relation to Declining SAT Scores. Report for the Advisory Panel on the SAT Score Decline (New York: College Entrance Examination Board, 1977).

(47) College Entrance Examination Board, On Further Examination, op. cit. at p. 9.

(48) In 1963, the year before the decline began, the mean SAT-V score was 478 and the mean SAT-M score was 502. By 1980, the mean SAT-V score had fallen 54 points to 424, and the mean SAT-M score had fallen 36 points to 466. See Sources cited at n. 24 supra.

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to-year changes over a period of 30 years, from 1952 to 1982, as of this writing, and provides at least a starting point for analyses of patterns of change and predictions based on them.

These data reveal that SAT mean scores were quite stable in this country from at least 1952 through 1963, varying by only a few points from one typical year to the next, and going up about as often as down. This was true on the verbal reasoning part of the test, the SAT-V, and on the mathematical reasoning part, the SAT-M, and it was true for total combined scores as well. The largest, single year-to-year change in mean scores on either the SAT-V or the SAT-M during this period was 6 points; the smallest was zero — on a scoreboard that runs from 200 points to 800. For combined scores, the range of year-to-year changes was from zero to 11 points.

This period of stability ended, as we can see clearly, in retrospect, in 1964, when means scores on both halves of the test began to go down, and continued to do so for a total of 17 almost-consecutive years. The one exception, the "almost," was in the 1976-77 period when scores on the SAT-M went up by 1 point. This dramatic, overall shift in direction was not, however, accompanied by any dramatic shift in the magnitude of year-to-year changes or, indeed, by any substantial changes in these magnitudes at all. From 1964 to 1980, the largest year-to-year change in SAT-V scores was 8 points; the smallest was zero. The range of change score magnitudes on the SAT-M was even smaller from 5 points to, again, zero. For combined scores, the range was similarly unchanged, from zero to 11 points.

This long, slow slide seems large enough to have the kind of cumulative economic impact suggested for it here, particularly in light of the fact that declines on the SAT were parallelled by declines of comparable magnitude on the battery of knowledge tests administered by the ACT(49) — the Iowa based American

(49) Albert E. Beaton, Thomas L. Hilton, and William B. Schrader, Changes in the Verbal Abilities of High School Seniors, College Entrants, and SAT Candidates between 1960 and 1972, Report for the Advisory Panel on the SAT Score Decline (New York: College Entrance Examination Board, 1977); Hunter Breland, The SAT Score Decline: A Summary of Related Research, Report for the Advisory Panel on the SAT Score Decline (New York: CEEB, 1976); T. Anne Cleary and Sam A. McCandless, Summary of Score Changes in Other Tests, Report for the Advisory Panel on the SAT Score Decline (New York: CEEB, 1977).

For evidence of declines on other tests from grade 5 onward, see Lerner, 1982, op. cit. Paul Copperman, "The Achievement Decline of the 1970s," *Phi Delta Kappan* 60, p. 736, June, 1979; Annegret Harnischfeger and David E. Wiley, Achieve-

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College Testing Program — and taken, in recent years, by about a half million prospective college entrants a year, in the midwest and, increasingly, in other parts of the nation as well. Of course, neither SAT nor ACT-takers are random samples of America's high school population or of her potential labor force as a whole. Taken together, however, the one and one-half million or so American 17 and 18 year olds who take these tests each year do constitute a reasonably adequate rough sample of the potential managerial, professional, and scientific replacement pool that America generated in the late 1960s and in the 1970s.

This pool, as we saw in Section 2 on traditional measures of higher abilities, was greatly expanded in the 1960s when the proportion of American high school graduates entering college rose dramatically. However, the great American score decline cannot really be explained away on that basis, for two compelling reasons. First, the expansion levelled off in the 1970s, but the decline did not; it accelerated.(50) Second, the decline was not just in the proportion of high scoring students but in the absolute numbers of them as well: there were fewer American 17 and 18 year olds with scores over 600 on either the verbal or the mathematical part of the SAT in the 1970s than there were in the 1950s.(51)

Something similar seems to surface in one of the few comparisons we have between American students in the 1970s and their predecessors in the 1920s.(52) In 1928, a 25-year old research assistant named Alvin C. Eurich prepared one of the early standardized tests of verbal reasoning abilities and administered it to high school seniors and to college freshmen in the

ment Test Score Decline: Do We Need to Worry? (Chicago: CEMREL, 1975); Wayne H. Martin, "National Assessment of Educational Progress," pp. 45-68 in John E. Milholland (Ed.), *New Directions for Testing and Measurement: Insights From Large Scale Surveys* (San Francisco: Jossey-Bass, 1979).

(50) Rex Jackson, A Summary of SAT Score Statistics for College Board Candidates. Report for the Advisory Panel on the SAT Score Decline (New York: College Entrance Examination Board, 1976a); Rex Jackson, An Examination of Declining Numbers of High-Scoring SAT Candidates, Report for the Advisory Panel on the SAT Score Decline (New York: College Entrance Examination Board, 1976b); D. Perry and E.O. Swanson, "Decline in Minnesota College Aptitude Test Scores," in J. Fasold (Ed.), *Decline in Standardized Test Scores: A Widespread Phenomenon* (Salem, Oregon: Oregon Department of Education, 1974).

(51) See sources cited at n. 50, supra.

(52) Fred M. Hechinger, "1978 Freshman Score Poorly on 1928 Exam," *New York Times,* March 18, 1980, p. C1.

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state of Minnesota. In 1978, he readministered it to samples of students drawn from the same schools. He compared students whose scores placed them in the top 1%, then and now, and found that in 1978, no student scored above 75 on this test – a drop of 20 points from the highest scores in 1928. Only one student out of 100 scored near 60 in 1978; 5 out of 100 did so in 1928.

What all of this suggests is that America may have entered a period in which high level managerial, professional, and scientific talent will be in short supply, a period when her stock of developed human capital is lower than it has been in the past, and in need of replenishing. How quickly can that be done? Available data reviewed above suggest that the average past rate of change was about 5 points a year, the maximum rate about 10 points. Thus, even if we assume that the decline ended in 1981 – and the evidence for that is, as yet, far from conclusive(53) – and that replenishment occurs at the maximum past rate, it would still take about 10 years before the scores of America's leadership replacement pool return to their former levels. This situation is likely to cause continuing economic problems for the United States until at least 1990, and perhaps beyond; it will, of course, pose challenging social and political problems, too.

The seriousness of these problems will depend, in part, on domestic factors: chiefly, the size of the cohorts involved and the efficacy of the steps taken to improve the performance of the affected cohorts, and of their successors. Improving the performance of successor generations is obviously important, but it will probably not, in and of itself, be enough to offset losses because of the size of the affected cohorts. The affected cohorts – Americans who came of age in the latter half of the 1960s and in the 1970s, for the most part – are the products

(53) In 1981, scores were the same as in 1980; in 1982, they rose by 3 points. See *College Bound Seniors,* 1981 & 1982 (New York: College Board). Obviously, two in a row is not yet a trend, but there do seem to be good theoretical reasons to expect improvements in functional literacy rates and, perhaps, in the development of higher level abilities as well. See Barbara Lerner, "The Minimum Competence Testing Movement: Social, Scientific, and Legal Implications," *American Psychologist,* October, 1981, pp. 1057-1066; Barbara Lerner, *Minimum Competence, Maximum Choice: Second Chance Legislation* (New York: Irvington, 1980). And, the experience of America's ethnic groups, as Thomas Sowell has shown, provide ample precedent for striking gains over time. See Sowell, "Assumptions versus History in Ethnic Education," *Teachers College Record,* Fall, 1981, pp. 37-71.

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of the post World War II baby boom in this country, and they are very large cohorts indeed, in both absolute and proportional terms.(54) As a result, the potential impact of retraining will also be unusually large, and it will be needed at the bottom level, to reduce the number of illiterate and semi-literate Americans as well as at the top level, to sharpen the abilities of America's younger managers, professionals, and scientists.

Domestic factors notwithstanding, the seriousness of America's human capital problems in the 1980s and beyond will also be determined, in substantial part, by patterns of human capital development in the rest of the world. Here, the examples provided by the United States and Japan should caution us against any automatic assumptions about the stability of the international patterns recorded on IEA tests in the late 1960s and the early 1970s. In both countries, domestic data on test score patterns over time highlight the prominence of change, and there is no good reason to assume that similar changes, up or down, will not occur in other nations — perhaps even in whole regions of the world — in the waning decades of this century. Some may already have occurred, and/or be in process. Thus, it is possible that the score decline reached western Europe, too, but with a bit of a time lag, as many cultural phenomena do, and there are some interesting non-psychometric indications that, for reasons of her own, the USSR may also be struggling with problems of human capital, and of standards. Certainly, post-cultural revolution China is, and, although we have no relevant test data to support it, it is a safe prediction that the Chinese problem is an especially formidable one.(55)

(54) The absolute size of cohorts born in the past is, of course, a known quantity, but their relative size depends, in part, on current and future birthrates. Updated census projections relevant to the latter are due out in March, 1983.

(55) Butterfield, op. cit., Simon Leys, *Chinese Shadows* (New York: Penguin, 1978).

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THE NEW ENTREPRENEURS

By Calvin A. Kent

This paper is based on certain premises which, when simply stated, lead one to wonder why the United States of America has followed policies which are so obviously not in its best interest. These premises, are:

1. The trends of the past decade brought our nation precariously close to economic disaster.
2. Behind these perverse and pervasive trends lies a fundamental problem: the erosion of productivity.
3. The decline in productivity is due to a misunderstanding of the role of the entrepreneur as the principal agent of economic progress throughout history.
4. The effects of this misunderstanding are highlighted in the initiation and expansion of government policies which are stifling entrepreneurship and capital formation.
5. These government policies have created a new class of entrepreneurs who add considerably to profits but do little to increase the quality of life or the rate of real growth in the economy.
6. Entrepreneurship in the United States is not dead — but it is misdirected.

I. The Trends of the Past Decade

There seems to be very little dissent among economists regarding economic trends in the United States over the past ten years.(1) This was a decade which saw the inflation rate accelerate from less than three percent a year to over thirteen percent before the recent decline. It was also a decade when unemployment refused to follow the historical precedent of falling as inflation accelerated, leaving the U.S. with the worst of both worlds: ruinous inflation and unacceptable levels of unemployment.

Over the past decade the average American has felt the results of soaring inflation, inflation induced automatic increases in income taxes, as well as a spectacular rise in social security levies. The Tax Foundation calculates that over the last ten

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years the average American family's income more than doubled but its federal taxes nearly tripled. When combined with the decline in purchasing power of the dollar due to inflation that typical American family can buy twelve percent less now than in 1972.(2) Perhaps the most optimistic assessment of current conditions was made by Herbert Stein who wrote, "It would be a mistake to say our present conditions are calamitous. They are not. But . . . (the) trends will produce calamity if long continued.(3)

II. The Productivity Problem

What lies behind the problems which we have experienced? It may be surprising to note the U.S.A. has neither an inflation problem nor a problem with unemployment. These problems are merely symptoms of the true disease – the erosion of the nation's productivity. Rising output per hour worked is what propelled the U.S.A. and its people from a tiny group of creative, hand-working colonists clustered on the eastern seaboard to the richest, most mechanized the world has ever seen: A nation rich enough to provide for the overwhelming majority of its people a living standard which the world could only envy.

During the past decade the productivity of the United States has steadily declined.(4) While productivity has recently improved slightly this was possible due more to the increase in unemployment than to improvements in real output. The U.S. productivity record is the poorest in the industrialized world, with a growth rate less than one-third the Japanese and only three-fourths that of the British – an economy we usually perceived as on its last legs. It has been estimated that if the U.S.A. had maintained its three percent productivity growth rate during the 1970s as it did during the 1960s, it would have $400 billion more in real output available either as personal income or as resources which could be applied to our social problems and upgrading our quality of life.(5) This amounts to more than $4,000 in real income which every family in America does without, because the nation's productivity has failed to keep pace with its historical standard.

As a nation, the U.S.A. has failed to invest in the new capital which its growing workforce needs if it is to be competitive. The U.S. rate of investment in productive capital has been the lowest of the industrialized countries with whom the U.S.

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competes.(6) At the same time, research and development expenditure reached a peak of three percent of GNP in 1964 and has declined steadily ever since. (7) When investment is depressed and the development of new technology is stifled, productivity declines. Old and antiquated capital equipment is replaced at a slower rate. The new technologies that expand output and create new jobs fail to materialize. Throughout the economic history of the U.S.A. periods of slow productivity growth have been associated with periods of rising unemployment and inflation.

In considering the productivity problem of the U.S.A., the Joint Economic Committee of Congress in 1979 issued a prophetic summary of the studies of many of the nation's most respected economists in this fashion:

> "The average American is likely to see his standard of living decline in the 1980s unless we accelerate the rate of growth in our nation's productivity. If no new steps are taken to address the problems of structural unemployment, lagging capital formation and a slowdown in productivity, then the American economy faces a bleak future .... A stagnating economy means more double digit inflation and less take-home pay for the average worker. It means protracted and rising unemployment ... for blacks and other minorities. It means a reduced standard of living and a time of such severe shortages and high prices ... that people will look back nostalgically and enviously at 1979."(8)

III. The Role of the Entrepreneur

The role of the entrepreneur in economic history is often lost, yet the venture initiator is the one largely responsible at all times and in all places for the development of the new technologies and mobilizing investment upon which economic progress has been based. Perhaps the entrepreneur's place in history has been clouded because academic scribblers cannot agree on what the definition is for entrepreneurship. At the Conference on Research and Education in Entrepreneurship conducted at Baylor University, twenty-one different definitions of an entrepreneur, or sets of criteria for the entrepreneurial function, were advanced in the papers presented.(9) The definitions range all the way from calling anyone who

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starts or manages a business an entrepreneur, to definitions requiring an entrepreneur to innovate a new product or technology and carry it through its development and marketing stages of rapid firm growth and expansion.

In this quest for an adequate defintion, few have done better than Joseph Schumpeter.(10) In his scheme the entrepreneur was an innovator who created new profit opportunities by devising a new product, a new production process or a new marketing strategy. The success of the entrepreneur did not result in an improved income only to himself. Entrepreneurial activity would open new doors to related technologies and products which other entrepreneurs would exploit. In this fashion the original innovation would unleash a "thundering herd" of imitators and exploiters who would further refine the product or technology. The results would either be a higher level of consumer satisfaction, lower costs of production or both. Put more simply, the end result of entrepreneurship is economic growth. Benjamin Higgins sees the entrepreneur as the key figure during the process of economic development.(11)

> "He is the man who sees the opportunity for introducing the new commodity technique, and brings together the necessary capital, management, labor and materials to do it. He may not be and historically has not been a scientific innovator. His skills are less scientific than organizational. His skills are also different than those of the salaried manager who takes over an enterprise after it has been launched. In any society, the rate of technological progress and of economic development depends greatly on the number and ability of entrepreneurs available to it."

As recent research has confirmed in the U.S.A., it has been small business — the entrepreneurs — who have contributed over half of all major U.S. innovations and created the majority of the nation's new jobs.(12) The conclusion is obvious: the solution to the nation's economic doldrums lies in maintaining and stimulating the entrepreneurial genius in America.

IV. The Perversity of Government Policies

What is the appropriate role which one can assign to the public sector in the promotion of the entrepreneurial tendencies which exist in the private sector? At the outset it should be noted that government policy is only one of many factors

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which compose the environment for entrepreneurship. (13) It is the contention of this portion of this paper that the government could create a favorable climate for entrepreneurship in the United States.

The Tax Environment

There seems to be a surprising agreement among economists that the current tax structure of the United States works against entrepreneurship in particular and capital formation in general. (14) All indicate that high marginal taxes on unearned income, the existence of a tax on capital gains and the failure to provide indexation of the corporate tax structure have not only significantly reduced the amount of capital available for entrepreneurial activity but have limited the supply of entrepreneurs willing to take risks. One essential idea behind supply side economics was to change the tax structure so as to encourage innovation and investment in new products and technology. (15)

Some of the recent changes in the tax laws are consistent with that objective. In 1981 the Economic Recovery Tax Act (E.R.T.A.) was passed with several provisions supposedly designed to encourage both investment and entrepreneurship. In total these would have reduced the cost of making new investments by as much as 30%. Regrettably, Congress, when faced with enormous budget deficits either revised or repealed most of these in the Tax Equity and Fiscal Responsibility Act of 1982 (T.E.F.R.A.) reducing by over half the incentives for capital formation given in E.R.T.A. (16)

But even before T.E.F.R.A., questions had been raised about the positive impact of E.R.T.A. on entrepreneurship. Congressional testimony indicates that the reduction in the maximum tax rate on capital gains from 28% to 20% has unleased significant amounts of additional venture funds for new business start-ups. (17) Even with the recent changes in tax policy, taxation of capital gains, which are payoffs for entrepreneurs, are estimated to be higher in this country than in any of the other economic "superpowers" of the free world. (18)

On the other hand, the Accelerated Cost Recovery System which allows faster depreciation write-offs of investment in plant and equipment will more likely benefit the larger more established firms than new ventures for two reasons. According

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to the Small Business Administration, the older, larger firms tend to use more capital per unit of output than do the smaller, new ventures which are more labor intensive. In addition the new ventures rarely show profits against which these credits can be applied.(19) The same arguments can be applied to the effectiveness of 10% investment tax credit contained in E.R.T.A.

Also included in E.R.T.A. was a provision for a 25% tax credit for research and development expenditures. The high technology firms, which could make use of this provision contribute disproportionately to the levels of investment and employment in the economy of the United States according to Senate testimony.(20) But these tax credits are only valuable if a firm has a positive tax liability against which these can be deducted. Most new ventures are not profitable during their formative years.

One of the more controversial aspects of E.R.T.A. was the "safe harbor" leasing provision. Under this provision a firm which had unused tax credits due to accelerated depreciation or investment tax credits could "sell" those credits to a profitable firm through the use of a "lease" arrangement on equipment. It was believed that without these "safe harbor" provisions much of the incentive effect of the tax cuts for investment would be dissipated as firms without taxable income would have no reason to invest. Evidence presented to Congress indicated that most of the firms with unused credits were smaller business.(21)

Unfortunately the first effects of the "safe harbor" provision was to assist certain highly visable large business with losses and other large business with profits who needed instant losses to reduce their tax liabilities. Congressional investigation revealed smaller firms being almost completely excluded from the first round of leases.(22) For that reason the T.E.F.R.A. virtually eliminated these provisions. But this elimination failed to remove the problem new ventures have with unusable tax credits and the need for a method to turn these into cash for investment purposes.

From the prospective of encouraging entrepreneurship the unfinished tax agenda includes provisions to allow the tax free reinvestment of capital gains and profits if these are directed toward new technology and innovative or for the establishment of a new enterprise. There is increasing skepticism even among supply side economists that the current tax structure provides

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the needed investment incentives for a positive entrepreneurial environment.(23)

The Regulatory Environment

In addition, the regulatory environment has become increasingly hostile to entrepreneurial activity. The Federal Paperwork Commission(24) concluded that the paperwork of federal regulations cost business between 25-32 billion dollars each year. This is paid by the public in higher prices, lower growth or both. Even more important are the hidden costs which retard innovation and technological advance upon which no dollar value can be placed. These hidden costs have been well documented by the Center for the Study of American Business.(25) The first of these is the increasing proportion of research and development budgets which are being devoted to defensive research: investment dollars which are going to meet regulatory requirements.

A second hidden cost is the delay in introduction of new technology and products. The longer it takes for new products to be approved for the market the less likely it is that entrepreneurial energy will be devoted toward their development. In addition, significant amounts of new capital are never invested at all because the funds are diverted to meeting environmental health or safety mandates of some federal agency. Denison(26) has estimated the potential productivity increases in the United States are reduced by fifteen to twenty-five percent due to this diversion.

All of this might be tolerable, if it were not for the fact that the regulatory climate is uncertain. The inability of government agencies to quickly and clearly establish and to maintain a consistant set of standards has added a further element of risk to the innovative process without increasing to any degree the potential payoff if that risk is taken. The U.S. Energy Resources Council has cited this uncertainty as a major factor in reducing attempts by the private sector to deal with the energy crisis.(27)

Since most entrepreneurial activity comes from smaller firms, the regulatory environment is particularly debilitating to the independent business sector. The result is negative effects on the environment for entrepreneurship. While most regulations do not discriminate between firms of various sizes, when a small

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firm must complete the same forms and adopt the same technologies required of a larger firm, then a significantly greater cost burden is placed on the smaller firm. Ken Chilton and Murray Wiedenbaum cite data and examples from the Environmental Protection Agency, the Employee Retirement Income Security Act, the National Labor Relations Board, the Occupational Safety and Health Administration, and the Securities Exchange Commission to support their contention that government regulation places a disproportionately heavy burden on the small business sector from which most entrepreneurial activity may be expected to come.

V. The New Entrepreneurs

The result of government regulatory policy is to divert a significant amount of the entrepreneur's attention from the traditional activities involved in developing new products and processes and to focus those efforts upon meeting standards of conduct, many of which may be of questionable value. What has been created by government taxation and regulatory policy is an environment for a new type of entrepreneurial activity. Unfortunately, this new activity neither increases national income nor produces any new products for the satisfaction of consumer wants.

Jonathan Hughes(28) feels entrepreneurship has and will continue to undergo considerable change because of the constraints created by government activity. While the entrepreneurs of the past were exploiters of technology and innovators of new products and processes, the new entrepreneurs must: "Be adept in the exploitation of federal, state, and local regulations at a time when the preponderence of power is on the side of the legislators who mold the entrepreneurial function to a large extent. The government sector is now the market, the exploiter."

Robert Reich(29) has referred to this as "paper entrepreneurialism." He contends the structure of the U.S. economy and its, "... underlying organization, the incentives it offers has discouraged long term growth in favor of short term paper profits. An ever larger portion of our economic activity is focused on rearranging industrial assets rather than on increasing their size. Instead of enlarging the economic pie we are busy reassigning the slices." The new entrepreneurs are the accountants, lawyers, and financial analysts who discover ways

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to make profits by exploiting the loopholes in the federal tax structure, avoiding agency regulations, organizing mergers and rearranging corporate assets to show a reduced pretax and increased after tax return to investors.

The basic idea behind "paper entrepreneurship" is to keep money moving into the areas of highest return and profit. Unfortunately, today this rarely involves investing in new factories, new technologies, new products or expanded capacity. All of these alternatives involve risk, the payoffs from which will be severely taxed. Instead of productive investment the money is used instead to effect mergers (particularly when stock is selling below book value), speculation in foreign currency, tax straddles and the generation of "paper losses." All of these activities may produce spectacular short term profits for the firm but do nothing to raise the productivity of American business or increase the satisfaction of the American consumer.

While a great deal of the blame for paper entrepreneurship can be placed on governmental policy, it must be recognized that the phenomenal pressure being placed on corporate managers for high, short term profits has also accelerated the trend. This is being recognized by some thoughtful corporate executives.(30) This short-run balance sheet mentality, which stresses today's profits at the expense of tomorrow's, results in low investments in research and development, reduced emphasis on the modernization and expansion of plant and general reduction in the future prosperity of the nation.

VI. The Misdirection of Entrepreneurial Effort

It is probably inappropriate for an author from a school of business which produces the accountant, the financial analyst, and the pre-law student to speak against paper entrepreneurship. But there seems little doubt the demand for services of the above mentioned professions, and the resulting high salaries, has been due in part to students following the ancient principle of economics and seeking the highest rate of return for their labor. It is significant to note that nations whose growth and productivity figures are better than those of the U.S. are placing a much larger percentage of their students in engineering and scientific pursuits and a much smaller percentage in law, public administration and business than is the United States.(31) The

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simple conclusion is that government policy in the areas of taxation and regulation has produced this unintended yet perverse effect in the labor market.

While government policy could promote entrepreneurship in the United States, it is not now so doing. Instead it is contributing to a static, "no growth" economy by creation of a new class of entrepreneurs. In the U.S.A., entrepreneurship is not dead, it is misdirected. There is no more damning criticism that can be made of government policy.

FOOTNOTES

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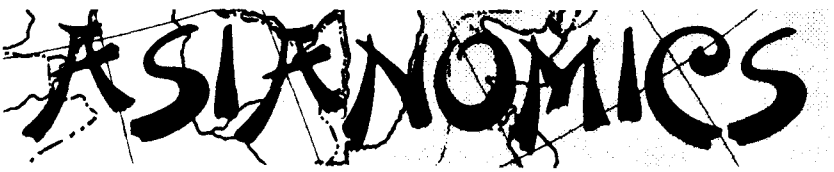

CHALLENGE AND CHANGE IN NORTHEAST ASIA

By Dr. Donald J. Senese

The author is a former Associate Professor of history who has taught the history of China, Japan and Korea. A traveller and writer on Asian events, he is a member of the Intercollegiate Studies Institute, University Professor for Academic Order, the American Council for Free Asia, the Japan-America Society and the Conservative Historians' Forum. His book MODERNIZING THE CHINESE DRAGON received a book recognition award from the Freedoms Foundation, Valley Forge, Pennsylvania.

INTRODUCTION BY REPRESENTATIVE JACK F. KEMP

in which the Congressman discusses how supply-side economics worked for Japan South Korea and the Republic of China

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DEFICITS AND THE ECONOMY

By Joe Stilwell

"We must get control of the budget monster, get control of our economy and, I assure you, get control of our lives and destinies."
Ronald Reagan: March 30, 1981

Two years after speaking those words, President Reagan remains further from controlling the U.S. budget deficit than any President has ever been. The reasons for this are numerous and debatable. The direct result, however, is clear – a $110 billion deficit for Fiscal Year 1982, the largest deficit in U.S. history. Unfortunately, the record will not stand for long. By any estimate, the deficits will be well above the $110 billion level through FY '88.

Past and Present Deficit Projections

The latest administration forecast projects a FY '83 deficit of $210 billion.(1) The President's July 15, 1981 "Mid-Session Review of the 1982 Budget" predicted a $500 million surplus in 1984 and a steadily growing surplus thereafter.(2) Currently, however, the FY '84 budget is projected to be $226 billion in the red. If the spending cuts requested by the President are adopted by Congress, and if the economic projections by the administration are accurate the expected deficit will "narrow" to $190 billion.(3)

Like Ronald Reagan, previous presidents also made balanced budget promises which they did not fulfill. In 1976, candidate Carter attacked the spending record of then President Ford and promised that if elected, he would balance the budget by 1980. Carter never did achieve a balanced budget. In the 1976 campaign, Ford, who presided over the largest deficit to that date, promised to balance the budget by FY '78 if he was reelected. Unfulfilled budget promises are not confined to recent years. During the 1932 presidential election candidate Roosevelt promised a balanced budget.(4) President Roosevelt then ran up a continuous string of deficits during the 1930s that, except for World War I, was unprecedented in both size and duration.

What really separates the present U.S. deficits from those of other presidents is sheer magnitude. Although many commenta-

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tors have claimed that the administration originally used a pessimistic economic forecast (which has since been liberalized) in estimating future deficit levels, the deficits could well be much higher than now predicted. Many outlays are clearly underestimated in the current budget. For example, the food stamp program will cost $2 billion more than budgeted this year, and there also will probably be a supplemental request for foreign aid.(5) Also, the costs of new weapons programs are being seriously underestimated.(6) More significantly, if Congress stays its course, it will not pass all of the temporary pay and benefits freezes or other requested budget reductions. Without these and related slowdowns in spending increases, the budget deficit will head toward the $300 billion level for FY '88.(7)

Downplaying the Effects

While most economists argue that the deficit trend cannot continue without grave consequences, some current and former government officials deny that the present deficits are damaging the economy. Norman Ture, supply-sider and former Undersecretary of the Treasury, claims that deficits did not cause the most recent recession and "History shows (that deficits) have no relation to interest rates, inflation or capital formation."(8) Walter Heller, of the Kennedy and Johnson administrations, maintains that "it would [not] make any sense to exorcise our deficit, even if we could, overnight."(9) Murray Weidenbaum, former chairman of Reagan's Council of Economic Advisers, says that "during a time of recession, such as the present, a large deficit will not be 'crowding-out' the rather modest funding needs of business and consumers."(10) William Niskanen, currently serving on the Council of Economic Advisers, says that deficits bear no relation to inflation and high interest rates.(11) Interestingly, Weidenbaum's and Niskanen's remarks came just after the first estimates of prolonged $100 billion plus deficits became public.

There are others who indirectly downplay the effects. Pete Domenici, the Senate Budget Committee chairman, has promised to keep federal deficits under $200 billion per year.(12) OMB Director David Stockman and Martin Feldstein, current chairman of the Council of Economic Advisers, were "pressing for a long-range plan" to limit yearly deficits to "only" $50

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billion by 1988. Despite occasional rhetoric to the contrary, those responsible for the deficits imply that America can live with budget deficits, and even hugh deficits, at least temporarily. The political reasons for the claims are obvious – no public official would admit to knowingly harming the economy for the sake of political expediency. Not so obvious, apparently, is the effect that deficits actually have on the economy.

Revenues

All economic units must finance their expenditures. Whether the particular economic unit is an individual, the local Rotary Club, or the federal government, it must pay for its spending. After revenues and expenses are tallied, any surplus goes toward savings and investment (or the repayment of past loans); any deficit must be financed through the draw-down of past savings or through borrowing. (The additional alternative available to the federal government – monetization – is explored below.)

Deriving its revenue from personal income taxes, corporate income taxes, social insurance, "contributions," and various excise taxes, the federal government's revenues increase when the level of taxation rises or when the dollar value of the activities and objects being taxed increases. Usually, Congress attempts to cover the gap between revenues and expenses by increasing the rate of various taxes (most recently, through the Tax Equity and Fiscal Responsibility Act, the 5-cent-per-gallon gasoline tax, and the acceleration of Social Security tax increases). The only revenue-increasing measure for which President Reagan has been commonly faulted by critics is the 1981 tax cut.

Arthur Laffer, one of the first to explicitly advocate the supply-side approach, claimed that cutting marginal taxes from their present rates would increase economic activity, thereby enlarging the number of taxable transactions to such an extent that government's total revenues would grow. President Reagan also claimed that the 25% tax cut would significantly stimulate the economy and minimize or avoid the recession. To date, however, the combined effect of the previously scheduled increase in Social Security taxes, bracket creep, last summer's Tax Equity and Fiscal Responsibility Act, and the 5-cent-per-gallon gasoline tax, along with the decrease in personal tax rates, produces a net change in total taxes of virtually zero.

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Writing last January, former Assistant Secretary of the Treasury and leading supply-sider Paul Craig Roberts compared the tax cuts versus tax increases since Reagan assumed office:

> [T]he 1981 tax cut measured about $960 billion (in static terms) over the 1982-87 period. It was 69% repealed before it was passed by scheduled Social Security tax increases and bracket creep of $660 billion, leaving a net tax cut of about $300 billion. TEFRA (Tax Equity and Fiscal Responsibility Act) repealed a further $229 billion, leaving a $71 billion tax cut. The 5-cent gasoline tax hike chipped away $16 billion leaving $55 billion.(13)

The net tax cut, $55 billion over six years, is equivalent to less than ¼ of 1% of the period's GNP. With the recently enacted acceleration of FICA tax increases, that last fraction of one percent has been eliminated. The "supply-side experiment," however, has left one interesting piece of evidence. Of all the income groups, only those who were in the highest income tax brackets actually had a real, net decline in their marginal tax rates. According to preliminary statistics for 1982's estimated quarterly tax receipts (which are primarily paid by those individuals with high incomes), total taxes paid by the wealthy increased by 11%, even after their tax rates had been lowered.(14) Apparently, supply-side claims of higher revenues held true for the only income group that actually had its tax rates lowered.

The 20-Year Record

Chart A illustrates the deficits since FY 1962. As the chart shows, the last budget surplus was in 1969. The net cumulative deficit for the period (excluding 1983) was $585 billion. This makes up 49% of the present $1.2 trillion national debt. Over 80% of the $585 billion was incurred during the past 10 years. Almost half of the 10-year deficit occurred in the past three years. And 1983's projected deficit is 93% of that three-year amount. Deficits are exploding.

To finance the deficits, the Treasury has sold bonds, notes, and bills to the public – the vast majority of which is short or medium term. Over 95% of the $1.2 trillion has a maturity of from just under 10 years to just over a few days. This forces the government to continually sell new issues to repay maturing issues. During an average week over the past several months, over $12 billion in T-bills were sold to pay for maturing bills

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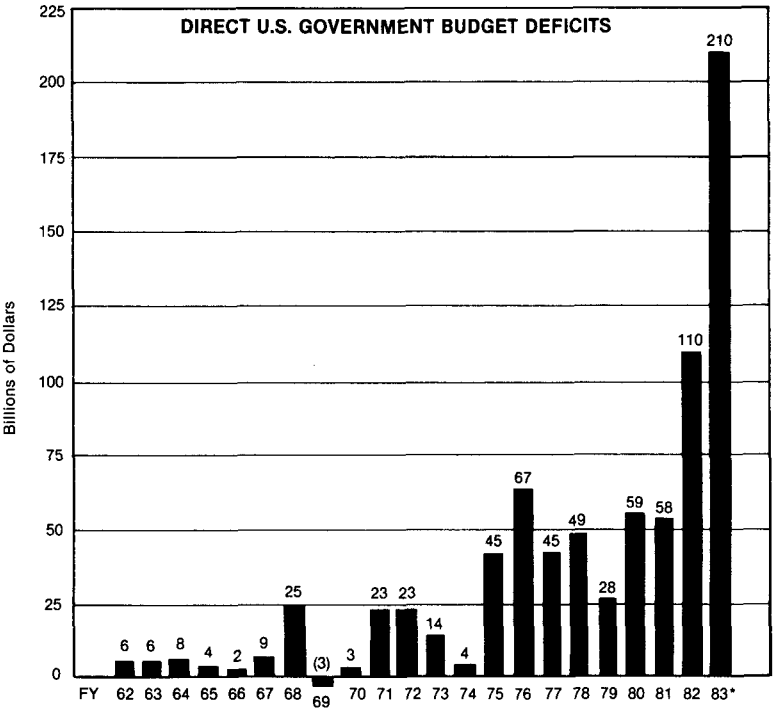
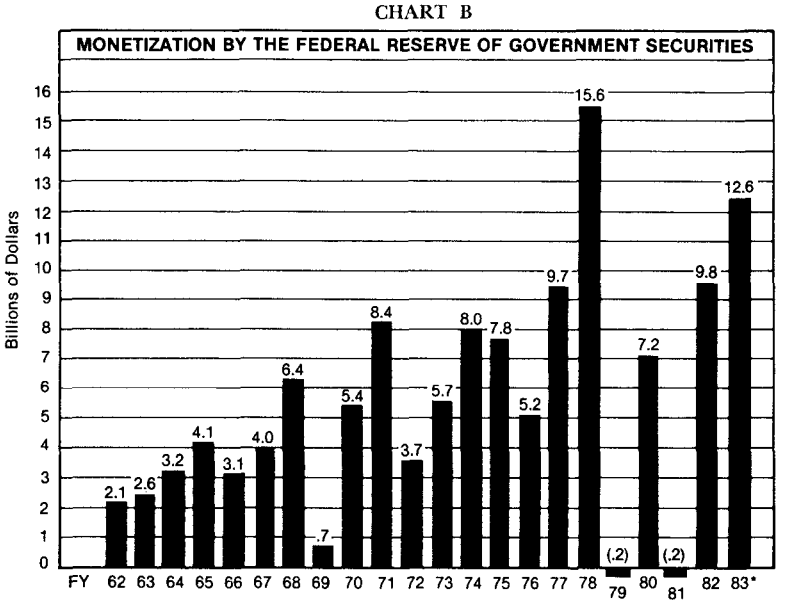
CHART A



*estimate
(Source: Office of Management and Budget)

CHART B



*Annual rate based on first 28 weeks.
(Source: The Federal Reserve Bank of New York)

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and to raise new cash. Also, during the first quarter of this calendar year, the Treasury borrowed $56.4 billion. For the second quarter, the Treasury estimates it will have a net borrowing need of $40.5 billion.(15) These amounts far surpass anything the federal government ever previously borrowed in such a short period of time.

In the 1970s, most sovereign nations were considered to be capable of repaying almost any loan. The famous phrase by Citibank's Walter Wriston, "Sovereign nations do not go bankrupt," rings hollow now. With the de facto defaults by Poland, Mexico, and other countries, and with the dangerously close-to-default situations in countries like Nigeria and Brazil, it is no longer believed that governments can always exact more money through either taxation or currency inflation. Nevertheless, lenders seldom consider where the money to repay the U.S. government's debts will come from.

To see how difficult repaying the national debt would be, consider this illustration. Beginning next year, the budget would have to move from a deficit in excess of $200 billion to a surplus of $50 billion. Then the $50 billion surplus would have to be repeated every year during the next *seven* administrations to pay off the direct federal debt. Lenders simply assume that government will always be able to sell more debt – both to finance future obligations and to refinance maturing obligations.

Monetization

Unlike other economic units, the federal government has an additional alternative available to cover its deficits: monetization. At the most basic level monetization is simply the creation of dollars. In a sophisticated financial system like the one in the U.S., the "new" dollars are entered into the bank accounts of individuals from whom Treasury securities are purchased. That simple act produces a series of consequences that throws the entire economy off balance.

The Federal Reserve System retains sole responsibility for monetization. It determines what portion of a deficit will be monetized and, consequently, the residual amount that will be net borrowing from the credit markets. By law the Federal Reserve is a public-private partnership; in practice it serves as the nation's semi-autonomous central bank, and it controls the

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base on which the country's credit system rests. Chaired by Paul Volcker, the Federal Reserve Board sets guidelines that determine how much debt will be purchased. The Federal Reserve Bank of New York does the actual monetizing.

To monetize part of the deficit, the New York Fed buys some of the Treasury's securities – and occasionally some municipal debt securities – on the open market, and it pays for the issues with newly created dollars. Doing so moves part of the government debt to the Fed (which effectively retires it), and the process adds more dollars to circulation. The process of adding dollars to the financial system is often referred to as monetary stimulus, easy money, or accommodating the deficit. Another name for it is inflating.

Chart B illustrates the amount of debt monetized during the past two decades (calculated on the present fiscal year calendar).

During the past 20 years, $112.5 billion of securities have been purchased by the Fed – effectively retiring an equal amount of the national debt. Although that amount is only 19% of the period's $585 billion budget deficit, the figures have a more significant effect than it might appear.

Each dollar of securities purchased represents one dollar put into the financial system. The dollars serve as cash and as reserves on which demand deposits are pyramided. As a result, the money supply (as defined by any of the M measures) increases, which leads to several consequences.

First, since the government spends newly created money, the demand for goods and services increases by the amount of new money spent, and businesses receive a temporary boost. The "new" money partially pays for the current construction of a subway in Pittsburgh and a subway link in Philadelphia, dairy and grain price supports, water projects in Western states, military contracts, and so on. Since these projects are partially financed by newly created money, overall demand for goods and services in the economy is greater than if the government had borrowed the money (thereby choking off other projects). The results of this extra economic demand are rising wages, profits, and employment levels – a temporary boost that ripples throughout the economy, satisfying business and labor. With this higher level of economic activity, aggregate taxes paid to government increase. However, as Nobel Laureate Friedrich A. Hayek points out, spending of "new" money causes econom-

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ic dislocations, and it leads to recurring business cycles. By injecting new money into particular industries, monetization distorts the flow of capital and encourages investments that are not based on true consumer demand.

Once the acceleration of monetization stops, consumer demand, prices, and interest rates adjust to their true market level, and borrowers who overextended themselves cut back their spending. As evidenced by 1982's post-war bankruptcy record, many businesses fail. In industries where wages were artificially bid up by the inflation's effects, wages must fall back to market levels or employment levels will be permanently lower. In the U.S., union contracts and worker attitudes have made the downward adjustment of wages extremely difficult. Unable to reduce wages, overextended auto manufacturers, for instance, have cut back employment levels of auto workers whose wages have been driven above market levels. Almost a half million auto workers are now unemployed. But after seeing the reality of unemployment, workers have recently begun to accept such unheard of ideas as the 32% compensation reduction at Weirton Steel and "givebacks" by numerous airline unions. New airline successes like People Express have been able to outmaneuver the giant airlines largely because their employees' wages were not set at artificially high levels. Price inflation confuses and misdirects economic assumptions, and ending the inflation is difficult because plans were based on inflation's continuance.

Note that the recessions during the past 20 years were all preceded by a sharp decrease in the amount of debt being monetized. The recession that began in late 1969 was preceded by a sharp cutback in the pumping of new money into the economy; after adding $6.4 billion in FY '68, only $700 million was added in YF '69. The '73-'75 recession was preceded by a cutback from $8.4 billion to $3.7 billion. (The situation was undoubtedly exacerbated by the dislocations resulting from the "oil shock.") The recession in the first part of 1980 followed a record cutback in monetization from $15.6 billion in FY '78 to -$200 million in FY '79. Monetization soared again during the election year of 1980, only to be cut back sharply in FY '81, causing the severe recession that began in the second half of calendar year '81. The economic history of the past 20 years is virtually a story of the Fed monetizing dollars to lower the interest rate to keep the economy "healthy," followed by

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an accelerating inflation rate, followed by a sharp cutback in money creation to slow the inflation, followed by the inevitable recession.

In addition to providing the temporary economic boost that increases government revenues, monetization also causes price inflation. Milton Friedman has spent much of his career studying the ties between increases in high-powered money (the dollars created when the Fed monetizes) and inflation. In the '60s, Friedman wrote that increases in the money supply are tied to increases in high-powered money,(16) and that the lag between the increase in the money supply and the acceleration of inflation varies between several months and several years.(17) Events support his analysis.

In FY '78 the Fed monetized $15.6 billion, the largest amount ever. A year later the inflation rate reached 13.3%, the highest rate (except 1946) since World War I. To slow inflation the Fed drastically cut its monetizing. The 1980 recession resulted, and the inflation rate began falling. But that inflation, and previous inflations, benefited the federal government.

As nominal wages increase with inflation, taxpayers are pushed into higher brackets. Thus tax rates are higher even though real income has not increased. This means most taxpayers suffer a decrease in their real, after-tax income. For example, with a 10% inflation, the average family earning $20,000 (and filing a joint tax return) will earn $22,000 the following year. Unfortunately, their federal income taxes move from $2,899 to $3,393 – a 17% increase.(18) (This will not occur if tax rates are indexed to the inflation rate, which is scheduled to begin in 1985.) Because the inflation-induced increase in income is taxed at a higher marginal rate, the family has a lower real income, and the federal government reaps the windfall in increased *real* taxes. This bracket creep provides government with a greater proportion of GNP.

The creation of money goes a long way toward reducing future deficits, but there are serious drawbacks. First, much of the deficit reduction comes at the expense of individuals who pay a higher percentage of their earnings to government. Price inflation continues to destroy much of the zero tax bracket's real value, and it moves people in the lower tax brackets to higher tax brackets.

The second drawback to monetization is that the business

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boom and higher real wages resulting from the initial monetization of debt are not temporary. Once monetization ceases, the jobs created and the higher wage rates supported by the initial influx of dollars do not have any real economic demand to maintain them. Demand that resulted from the "extra" dollars attempting to purchase a limited quantity of goods and services disappears without the creation of additional new money. Although many "extra" jobs and the higher wages could be maintained through increasing the rate of monetization, the corresponding rise in the inflation rate eventually makes this option unpalatable. Recent events provide a vivid illustration.

When price inflation reached 13.3% in 1979, the electorate and the politicians found the inflation rate unacceptably high. Between the time when double-digit inflation first appeared in 1978 and the end of FY '1982, the Fed only monetized 6.5% of the deficits – a significant decrease compared to its former practices. The result was a 3.9% inflation rate in 1982. Unfortunately, to speed the economy out of recession and lower future deficits, the Fed has been monetizing large amount of debt since the beginning of this fiscal year. Based on figures for the first 28 weeks of FY '1983, the Fed can be expected to monetize $12.6 billion this year, a higher level than in any previous year except 1978, when the highest-ever rate of monetization was followed in 1979 by 13.3% inflation. With or without declines in the price of oil, union wages, the amount of monetization presently occurring will cause an accelerating inflation rate by the end of 1984. (If the Fed slows the rate of monetization enough to avoid a resumption of inflation, the recession will resume and continue to adjust wages, profits, and prices toward market levels.)

The Effects of Borrowing

Once a deficit has been incurred, the other financing option available to government is borrowing. To borrow, the Treasury sells the previously mentioned bonds, notes, and bills in the credit markets. Although borrowing does not create price inflation, it does produce two interrelated and harmful consequences: higher interest rates and crowding-out of private investment.

The interest rate measures the cost of borrowing money over time. It equilibrates the supply of, and the demand for, funds.

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Whenever the demand for funds exceeds the supply, the interest rate rises until the two are equal. With higher rates fewer individuals or businesses are willing to pay the price for borrowing money, and more people are willing to save. Aggregate borrowing declines; aggregate saving rises; and at the constantly fluctuating interest rate, the supply of funds balances with the demand for funds.

Price inflation influences the interest rate because it affects the value of money. With a lower expected value of future money, savers do not provide the same amount of money until their rate of return (the interest rate) increases enough to make up for the expected loss of the money's future purchasing power and for the risk that inflation will be higher than expected. Inflation cuts back the supply of funds at any given interest rate, and rates rise until the supply and demand of money again equal each other.

Individuals and corporations supplied funds to the credit markets in 1982 through their gross private savings of $549 billion. (19) After subtracting $360 billion in depreciation costs (that part of gross savings that theoretically covers the wear and obsolescence of capital assets), net private savings of $189 billion remained. (20) To the degree that actual depreciation equaled accounting depreciation, net savings was the amount available for investment in new economic enterprises. If government had had a balanced budget in 1982, the total net national savings would have been invested in private enterprises, and the amount represented by depreciation costs would have been reinvested.

With the federal government running budget deficits, the natural relationships between private borrowers and lenders become distorted. In 1982 the Treasury borrowed $144 billion from the credit markets (the reported deficit plus $16 billion of agency borrowings and $17 billion in "off-budget" items). (21) Government borrowing increases aggregate demand for money without increasing aggregate supply. The increased demand caused the interest rate to rise to a level above what it would otherwise have been. How much further it rose cannot be measured, but it can be estimated. From 1982's T-bill rate of roughly 10%, the "natural" rate of interest – the rate that would exist in the absence of inflation and government borrowing – of approximately 2.5% should be subtracted. In addition, the year's inflation rate of 4% and an inflation risk premium of

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about ½% must also be deducted. The amount remaining, 3% of last year's short-term rate, was arguably due to government borrowing. Although the calculation is imprecise, it serves as a good estimate of how much short-term interest rates rose because of the federal government's borrowings last year.(22)

Not only do the higher interest rates make borrowing more expensive for both consumers and businesses, they also cause some of those who would have borrowed at the natural interest rate to drop out of the markets as demanders of credit. Because the government has huge taxing powers, lenders feel a higher degree of confidence in its ability to repay its borrowings than they do in any individual or business.

Adding to its advantage of perceived risklessness, the Treasury pays whatever the current interest rate happens to be when it borrows. Consequently, the government always receives the amount that it wants to borrow, and private borrowers are partially "crowded-out" of the credit markets. Instead of private concerns receiving all of the savings generated by the economy, the government appropriates much of it for its purposes. Last year, the federal government borrowed 76% of the nation's net private savings, leaving only 24% for private borrowers. A record $215 billion is projected as necessary to cover the deficit and other federal spending in 1983, and $203 billion in 1984.(23) Most estimates of the percentage of net national savings that will be appropriated by the federal government during the next two years range from 90% to 110%.(24) This depletion of capital stock is setting the stage for even more serious long-term economic problems.

The effects of crowding out are compounded by a myriad of government credit programs. By providing guarantees and/or subsidized borrowing rates for everything from FHA mortgages to student loans, the government is moving those people and businesses who qualify for the special loans ahead of others in their attempt to borrow. Federal loan and guarantee programs provided $101.3 billion in 1982. In 1983, $151.8 billion in loans will be subsidized and guaranteed, and the administration has asked Congress to approve $137 billion for 1984.(25)

Subsidized lending, above and beyond what was borrowed to cover the deficit, redirects resources from their most productive uses to less efficient uses. Although some of the credit is rechanneled toward private concerns, these funds are almost always allocated on a political rather than an economic basis.

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Loans encouraging overproduction of grain by farmers, subsidies for FHA and VA mortgages, and guaranteed loans for small businesses are all examples of a government taking money from the highest bidders in the loan markets and giving it to political constituencies. In addition, most of the regular budget goes toward transfer programs that subsidize consumption and ignore investment, or toward military expenditures. Loan guarantees and subsidy programs rechannel credit from concerns with the most viable economic enterprises to politically favored projects.

With government borrowing most of the nation's net savings, there is little net increase in the economy's capital stock. When subsidization rechannels capital that should be replacing depreciation to less effective areas, the value of the nation's capital stock declines. It is no wonder that productivity has lagged.

Prominent Rationalizations

While the amount of the budget deficit has soared seemingly out of control, those responsible for the deficit have looked for excuses either to rationalize why the deficit is not really all that harmful or to explain why they are not really responsible for its magnitude.

To avoid the difficult choices that congressmen would face in cutting the budget, many have hoped that the economy can grow fast enough to provide more tax revenues and balance the budget without spending cuts. As the YF '85 Federal Budget document points out, if the economy grows 1 1/3% larger per year than the projections assume, the budget will be balanced in 1988. This is true, but it also assumes that the requested spending cuts and cost-of-living freezes will be enacted by Congress. So far, enactment of those cuts does not appear likely. The budget document also projects that without them the annual deficits will expand to over $300 billion in 1988. The indications are that without radical spending cuts, the deficit will be even higher than the supposed worst-case scenarios laid out by the administration.

Three recent items illustrate how spending is likely to grow more and at a faster rate than anticipated.

1) Reversing its earlier opposition, the administration supported a $4.65 billion jobs program, which will increase the deficit by several billion dollars.

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2) The Social Security Administration in February re-estimated that expenditures will exceed FICA taxes over the next 75 years by $300 billion more than estimated at the time of the bipartisan compromise several weeks earlier.(28) This higher amount is also not included in the deficit projections.

3) In a presentation to the Senate Armed Services Committee that the Pentagon tried to prevent, Senator John Tower sought to keep quiet, and Caspar Weinberger attempted to discredit, Pentagon analyst Franklin Spinney explained why the arms buildup will produce roughly $500 billion in overruns.(29) None of that $500 billion is currently included in expense projections.

There are sure to be more expenditures that will lead to larger than projected deficits. Also, since virtually all of the net national savings now goes toward covering the deficit, new investment will suffer to such a degree that the economy may well grow at a *slower* pace than the current budget predicts over the next five years.

Conclusion

If the estimated deficits for FY 1984 and 1985 were included on the first chart, each would be almost triple the once-record deficit of 1976. Even the most optimistic estimates now place the direct (on-budget) deficit at higher levels for the foreseeable future than any previous deficit. The specific effects of these deficits will depend on the Fed, but only three possibilities exist — higher price inflation, higher real interest rates, and lower productive investment (plus the various combinations of them).

In recent testimony before the House Budget Committee, Chairman Volcker alluded to the same problem: "[T]here isn't a monetary policy that can successfully resolve the economic and financial tensions that would arise from the clash of demands in the money markets from excessive deficits in a growing economy."(30) In other words, the Fed has no magic wand to wave that will lower interest rates and provide investment funds to business with budget deficits at their projected levels; that is, it cannot be done on a permanent basis. A short-term solution does exist, however, and it appears that the Fed is using it.

Monetization will eliminate some of the short-term strains on the financial markets, and interest rates will fall in the short run. Although it does temporarily ease the strains on the

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financial system and the economy, high levels of monetization will result in a resurgence of price inflation and backbreaking interest rates in a year or so. Despite Volcker's recent statements to the contrary, the figures from FY 1982 and the first half of FY 1983 indicate that the Fed has embarked on another round of inflating. Stopping now will lead to a resumption of the recession; continuing will lead to accelerating price inflation.

Perhaps those who have the power to affect the deficits are hoping that Paul Volcker can walk the fine line between prohibitively high interest rates, weak capital formation, and accelerating price inflation. Perhaps they nourish a hope that something will occur that changes the deficit outlook. Or perhaps they are simply misleading themselves and the American people about the true effects of the deficits on the nation's economy.

According to present projections, the direct debt will double in six years. Other federal debts are growing rapidly, and deficits are now escalating in real dollars, as a percentage of GNP or by almost any other measure. The United States' present economic condition has resulted from living beyond its means. Unless the trend is halted, the result, quite naturally, will be a long-term, deteriorating economic climate.

In the final analysis, government deficits represent the spending of resources in excess of those that the government "owns." And like all debts, it will someday come due. The total debt is not a debt that "we owe to ourselves"; the debt is owed by government only to those who have directly or indirectly lent it money. It will be the American people who will pay the cost — in the form of inflation, higher interest rates, and the decreased economic vitality that results from capital investments being crowded out.

This article was prepared under the auspices of The Cato Institute, Washington, D.C.

FOOTNOTES

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(2) Office of Management and Budget, "Mid-Session Review of the 1982 Budget," July 15, 1981, p. 70.

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THE SUPPLY-SIDE ALTERNATIVE: REAGAN AND THATCHER'S ECONOMIC POLICIES

By Charles Redenius

Serious economic problems – a high rate of inflation, an upward trend in unemployment, and periodic recessions – have troubled the economies of the United Kingdom and the United States since the first Arab oil embargo in 1973. The perceived failure of Keynesian demand management policies to ameliorate these problems led to the election of leaders in America and Britain determined to refashion economic thinking and redirect the economic policies of their governments. In the United Kingdom, the public sector unions' "Winter of Discontent" in 1978-79 with Labor Prime Minister James Callaghan's attempt to reduce inflation with an incomes policy was followed by the election of a Conservative government in May of 1979. In the United States, President Jimmy Carter's seeming inability to advance policies that would restore economic health resulted in a crushing Republican victory in November of 1980.

The newly-elected leaders, Prime Minister Margaret Thatcher and President Ronald Reagan, convinced that Keynesian economic policies were both ineffective and the principal cause of the current economic malaise, enunciated an economic philosophy grounded on a set of economic assumptions deeply conservative in nature – an elitist theory of economic growth, a limited role for government in restoring economic health, and a belief in the "natural" superiority of economic laws and the market as the most efficient allocators of resources. These conservative assumptions inform the supply-side economic policies adopted in America and Britain.

It is the purpose of this paper to review certain aspects of American and British economic problems, to examine the assumptions of supply-side economics, and to sketch how the supply-side economic policies adopted in the United Kingdom and the United States relate to those assumptions. (1)

ECONOMIC PROBLEMS

Inflation:

Many students of political economy see inflation both as a

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major source of the current economic malaise and as the reason for the poor performance of the American and British economies during the 1970s and now the 1980s. Inflation also contributes to higher and more volatile interest rates, automatic increases in taxes (where they are not indexed), and the depreciation of both the dollar and the pound against other currencies. Whereas certain Keynesian economists see inflation as the contemporary manifestation of the instability of capitalist economic systems, supply-side economists and monetarists insist that inflation is the direct consequence of a too rapid growth in the money supply. Milton Friedman, the foremost monetarist, has asserted: "There is perhaps no empirical regularity among economic phenomena that is based on so much evidence for so wide a range of circumstances as the connection between substantial changes in the stock of money and the level of prices."(2)

Both the political systems of Great Britain and the United States have had an inflationary bias in the post-war era. Both governments have engaged extensively in deficit spending. Supply-side economists argue that this reliance on deficit spending, in combination with a too rapid growth of the money supply, have been powerful factors contributing to the high rates of inflation that plagued both nations for most of the last decade.

Inflation is also the result of rapidly rising energy costs. Since the Arab oil embargo of late 1973, the constantly escalating price of petroleum has spurred inflation. Although Great Britain is now energy self-sufficient, the nation still must pay the market price for petroleum. The United States has managed to slow the growth of energy consumption, but the economy has not been immune from the adverse effects of the price increases mandated by OPEC. Given the oil glut of the early 1980s some of these adverse effects will be ameliorated as economic recovery diminishes the effects of recession.

Table 1 furnishes the inflation figures for both countries since the initial Arab oil embargo. The 1973 date has been used throughout this paper because the escalation of energy prices signaled a fundamental change for the worse in all of the indices used here.

Both the Thatcher government and the Reagan administration have made the task of lowering the inflation rate their primary goal. In order to reach this goal, they have pledged to

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TABLE 1

Inflation Rates in Great Britain and the United States
1973-1982

	Great Britain	United States
1973	9.2	6.2
1974	16.1	11.0
1975	24.2	9.1
1976	16.5	5.8
1977	15.8	6.5
1978	8.3	7.7
1979	13.4	11.3
1980	18.0	13.5
1981	11.9	10.4
1982	8.6	3.9

SOURCES: *Employment Gazette,* Retail Prices, Selected Countries: Consumer Prices Indices
Federal Reserve Bulletin, Consumer and Producer Prices

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restrain monetary growth, to cut government spending, and to begin taking the other necessary actions toward balancing their respective budgets. Such policy steps, advocates of supply-side economic policies insist, constitute the most effective action government can take to dampen inflation.

Unemployment

Keynesian economists maintain that capitalist systems have failed to create a sufficient number of market supported jobs over the long term. Supply-side economists counter by arguing that government policies have impaired the incentives to invest and to produce that would ensure full employment. Whichever is the case, the facts show a deteriorating trend with regard to employment since 1973 in both Great Britain and the United States.

Keynesians accuse the supply-siders and the monetarists of being willing to trade off a lower rate of inflation against a higher rate of unemployment. Supply-side economists respond by pointing out that it is possible to have both a high level of employment and a low rate of inflation. The early 1960s in the United States was a period of high levels of employment coupled with a low inflation rate. Thus, the supply-siders argue that an attack on inflation in the 1980s need not necessarily produce high levels of unemployment in the *long run.*

Sub-employment is also a major problem in both the American and the British economy. Income discrimination against women, the young, and minorities causes substantial numbers of people to be employed below their skill levels. Even more disturbing is the substantially higher rate of unemployment for each of these groups when compared with white males.(3) In the United States, liberals fear that President Reagan's deemphasis of affirmative action will worsen the economic position of the nation's minorities. In Great Britain, the urban disturbances of the young unemployed in the Spring and Summer of 1981 revealed the desperation and the frustration they felt with the lack of job opportunities. In both nations as women have increased their share of the labor force, they have become painfully aware of the wage differentials between men and women.

Yet it is the overall rate of unemployment that is causing the most concern. Since 1973, and especially since 1979, unem-

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ployment has surged upward and government policies have seemingly had little effect in bringing the rate down. Table 2 reveals the upward trend for both nations.

Neither the Reagan administration nor the Thatcher government have made combatting unemployment their principal goal. Although both leaders express dismay at the high level of unemployment, it is clear that they regard curbing and stabilizing inflation as their primary problem. Thus, neither leader is willing to back policies designed to lower unemployment if such policies would, in any significant way, hinder the fight against inflation. Furthermore, the supply-side advisers of the president and the prime minister maintain that bringing inflation under control will have beneficial effects on the unemployment rate. With inflation restrained, healthy economic growth will create, supply-siders insist, the necessary new jobs to bring down unemployment.

Productivity:

Productivity has slowed in both Great Britain and the United States since 1950. From 1870 to 1950 the United States and Great Britain had the world's highest productivity rates. In that time period the United States and Great Britain averaged roughly 3 percent productivity growth per year while Germany and Japan averaged roughly 1 percent per year.(4) After 1950 Germany and Japan forged ahead while the United States and Great Britain lagged further and further behind. Indeed, the last decade has witnessed a dramatic reversal in the fortunes of the respective nations. Since 1973 the United States has averaged .78 percent increase in productivity per year while Great Britain has averaged .48 percent per year. During the same time period productivity rose almost 4 percent per year in Germany and over 5 percent per year in Japan. Table 3 details the figures in productivity growth for Great Britain and the United States since 1973.

Some economists see the lag in productivity as the real source of inflation and unemployment. As Great Britain and the United States lagged in productivity, the inflation rate and the unemployment rate in both nations began to creep up. As productivity gains came nearly to a halt in the later 1970s, the inflation and unemployment rates shot up.(5) Thus, these economists argue that the only effective way to bring down

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TABLE 2

Unemployment Rates in Great Britain and the United States 1973-1982

	Great Britain	United States
1973	2.6	4.9
1974	2.6	5.6
1975	4.1	8.5
1976	5.6	7.7
1977	6.0	7.0
1978	6.0	6.0
1979	5.6	5.8
1980	7.3	7.1
1981	11.3	7.6
1982	12.5	9.7

SOURCES: *Employment Gazette,* Unemployment in Great Britain
Statistical Abstract of the United States, Unemployment and Unemployment Insurance – Summary 1970 to 1979
Survey of Current Business, Labor Force, Employment, and Earnings

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inflation and unemployment permanently is to adopt economic policies that will enhance productivity. Precisely what those policies should be is a source of debate between Keynesians and supply-siders.

Keynesians argue that a positive role for the government in the economy has been shown in the cases of Germany and Japan(6) to be a proven way to enhance productivity. The United States and Great Britain should study the economic policies of those two countries and adopt those policies best suited to their economies. Thus, Keynesians rather than seeing a diminished role for the government envision a prominent role for government for the foreseeable future.

Proponents of supply-side economic policies argue that one of the principal reasons for the decline in the growth of productivity has been the dramatic increases in tax rates. This is particularly true in the United States where tax rates have increased rapidly since the tax cut of 1964. The rise in tax rates has seriously impaired incentives to work, to save, and to invest. To restore those incentives, taxes must be cut which also implies a diminished role for government.

The slowing of economic growth that has accompanied the lag in productivity growth is forcing both Great Britain and the United States to face some rather difficult distributional issues. Each nation in its attempts to resolve the problems plaguing the economy must impose policies that will result in real income losses for some groups. Whether either Ronald Reagan or Margaret Thatcher is able to do so will affect the quality of their government's response to their economic problems. Powerful groups stand ready to ensure that their interests and their incomes are not adversely affected by public policies designed to combat inflation, unemployment, and low productivity.(7)

A further complication can be traced to the fact that both Great Britain and the United States have an aging industrial plant. The steel industries in both countries are a case in point. Now technologically backward, the privately owned steel industry in the United States and the publicly-owned steel industry in Great Britain have productivity rates substantially lower than the productivity figures for the Japanese steel industry. Overall, an economic stystem with an older industrial plant can be expected to have a lower productivity rate than an economic system with a newer industrial plant.

As the economies of Great Britain and the United States

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TABLE 3

Productivity Growth in Great Britain and the United States 1973-1981

	Great Britain	% Change	Avg.	United States	% Change	Avg.
1973	103.5			94.8		
1974	101.5	-1.93		92.5	-2.43	
1975	100.0	-1.48		94.5	2.16	
1976	102.1	2.10		97.6	3.28	
1977	103.6	1.47		100.0	2.46	
1978	105.8	2.12		100.6	0.60	
1979	106.6	0.76		99.6	-0.99	
1980	105.7	-0.84		98.9	-0.70	
1981	107.4	1.61	0.48	100.7	1.82	0.78
1975 = 100				1977 = 100		

SOURCES: *Employment Gazette,* Indices of Output, Employment and Productivity
Monthly Labor Review, Annual Indexes of Productivity, Hourly Compensation, Unit Cost, and Prices, Selected Years, 1950-1981

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worsened during the 1970s, economic security demands on the part of both managers and workers came to be of increasing importance. These demands have had the effect of limiting technological innovation. Unfortunately, granting demands for economic security locks the economy "into current activities and makes it more difficult to shift to the new products and processes that are the heart of economic progress. The problem is to combine economic progress with economic security when to a great extent they are mutually incompatible."(8)

With barriers to technological change being insisted upon by both managers and workers determined to protect their jobs, productivity is adversely affected. To resolve these issues government policy in both Great Britain and the United States must address the problem of economic security or their policies designed to enhance productivity must necessarily have a limited impact. Given the high levels of unemployment in both nations, demands for economic security will continue to be a force to be reckoned with for the foreseeable future.

Enhancing productivity growth has been a concern of both the Thatcher government and the Reagan administration. Both leaders have spoken of the revitalization of the private sector, and, in a more sweeping manner, of the reindustrialization of their respective economies. Yet both the prime minister and the president see a diminished role for government in this process. The supply-side advisers of Mrs. Thatcher and Mr. Reagan insist that all government need do is to create a favorable economic climate and the interplay between enterprising individuals and market forces will result in a surge of technological innovation, a rise in productivity, and healthy growth for the economy as a whole.

Disaffection with Keynesian Economics

American and British economic policies failed to produce price stability and high growth rates during the 1970s after the economic successes of the 1960s portended an era of economic prosperity. The Keynesian economic policies adopted by both governments apparently worked well until late in the 1960s. Since then such policies have seemingly been unable to come to grips with the persistent problems of inflation, unemployment, and low productivity. From the vantage point of the early 1980s, it now appears clear that the economy does not consis-

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tently respond in the way Keynesians predict. Indeed, the stagflation (stationary or declining output coupled with high inflation rates) of the 1970s seemed to indicate that the economy responded in precisely the opposite way to Keynesian expectations. Keynesians counter such observations by insisting that the price shocks occasioned by OPEC price increases and the abnormal conditions that prevailed during the brief period of time under consideration significantly hampered the effectiveness of demand management economic policies.

By contrast, supply-side economists hold that low productivity growth and high inflation rates are the direct result of Keynesian (demand management) economic policies. They point out that recent administrations in both countries used the traditional Keynesian tool of tight money and the appropriate fiscal policies to produce idle capacity. Not only did such policies fail to combat inflation, but the resultant idle capacity exacted a stiff price in terms of slower productivity growth. Advocates of supply-side economic policies insist that the obvious remedy to the economic problems of inflation, unemployment, and low productivity is to focus economic policy making on restoring financial incentives. Such a focus is necessary because policies that restore financial incentives are the only reliable way to bring about growth in aggregate output and to enhance growth in productivity.

To add to the debate about the direction of economic policy, the proponents of supply-side economics pointed to the budgetary deficits incurred by both Great Britian and the United States on a regular basis as a part of Keynesian economic management. During the past half century, the United States experienced budgetary deficits in all but eight years. Since fiscal 1973, budgetary deficits have averaged $49.4 billion per year.(9) Despite the size of these numbers, budget deficits in the 1980s will be approximately 3 percent of the gross national product.

The deficit experience is much the same for Great Britain. The public sector borrowing requirement (PSBR) for 1980-81 was 13.5 billion pounds, or about 6 percent of the gross domestic product. For 1981-82, the PSBR was expected to be around 10.5 billion pounds, or about 4¼ percent of GDP. Sir Geoffrey Howe, the Chancellor of the Exchequer, hopes to cut the PSBR to 9.5 billion pounds, or about 3.5 percent of GDP, for 1982-83.(10)

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According to supply-siders, these budgetary deficits, which were countenanced by Keynesians, fueled inflation and impaired the private sector as well as the operation of the market.

Given the perceived failure of demand management economic policy, the disaffection with Keynesian economics led to a turn to the political right at the polls in both countries. However, even before the election of Margaret Thatcher and Ronald Reagan, a number of key governmental officials in both countries were already questioning the efficacy of demand management economic policies. Denis Healey, Chancellor of the Exchequer during the Labour governments of Prime Ministers Edward Wilson and James Callaghan, insisted that the British government could not spend its way out of recession, indicating a profound dissatisfaction with Keynesian policies. David Stockman, director of the Office of Management and Budget in the Reagan administration, admitted that "there was a kind of consensus emerging for" budget cuts "even before this administration."(11) Thus, the elections merely confirmed a trend already in existence.

The Supply-Side Alternative

Overall, it is a principal tenet of supply-side theory that economic behavior as a whole will react positively to increased financial incentives, that is, enhanced opportunities for money making and for profit. Supply-side advocates insist that it is the decentralized, individual, private decision maker (rather than the centralized, collective, public sector decision maker), who is the most significant and most efficient allocator of a nation's economic resources. Government intervention in economic affairs hinders the functioning of market forces and restricts the actions of talented individuals. Economic individualism, and not interventionistic government policy, is the key to economic health.

Moreover, the proponents of supply-side economics go further and place the emphasis on producers or those more likely to be producers than consumers. There is a deliberate attempt on the part of supply-side economists to persuade the managers of the economy to shift resources to the higher income groups and to industry. The reasons for this are, to the supply-sider, obvious. It is the interrelationship of free market forces and enterprising individuals that is crucial to economic

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prosperity. Planned, non-market economies, or those where government policy impairs the functioning of free markets, are simply unlikely to draw on either the advantages of the market mechanism or of enterprising individuals.

One of the fundamental arguments of the proponents of supply-side economic policy is that the persisting economic problems of the last decade and a half are the immediate result of increasing taxes on all sources of income that decrease the financial incentives to save, to invest, and to produce. If tax rates are reduced and government expenditures pared down the monies reallocated to the private sector will furnish both the incentive and the funds to invest and to renew productivity growth.

Arthur Laffer, the best known supply-side theorist, argues that "tax rate reductions increase employment, output and goods, and lower unemployment rates, and lower inflation."(12) The upsurge in economic activity flowing from tax reductions will ensure, he insists, in a brief span of time, that government tax receipts do not decline and bring about outsize governmental budgetary deficits. Thus, tax reductions benefit not only the well-being of the economy, but also the well-being of governmental budgets.

Both Reagan and Thatcher have accepted this argument and have attempted to cut taxes. Reagan's tax cutting proposals are designed to be an "integral part of the comprehensive economic program" to improve "the after-tax, after inflation rewards to work, saving, and investments.(13) Thatcher's proposed cuts in taxes extend across the entire range of tax policies from personal and corporate income taxes to custom and excise levies.(14) Yet despite the tax cuts, increases in value-added taxes and social insurance taxes, "bracket creep" and the adoption of "user fees" and other "revenue enhancement" measures have ensured that real taxes are still rising for most income groups in both America and Britain.

Hand-in-hand with the tax proposals have come urgent calls for fiscal restraint. Both Reagan and Thatcher have attempted to slow budgetary growth. Indeed, President Reagan maintains that he has, in effect, instituted a comprehensive freeze on total federal spending. Government spending in fiscal 1984 will rise no more than 5.4%, which is the projected rate of inflation for that year.(15) The Thatcher government has called for a reduction in government spending as a proportion of gross domestic

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production from 45 percent in 1981-82 to 44.5 percent in 1982-83 and 41 percent in 1984-85.(16) This slowing of budgetary growth will also, it is argued, return resources to the private sector where they are needed if healthy growth is to occur. Yet as Table 4 reveals, budgetary growth had already slowed before the election of Reagan and Thatcher. Despite the efforts at fiscal restraint huge budgetary deficits in the United States are projected for the next several years. President Reagan's fiscal 1984 budget projects deficits of $188.8 billion in 1984, $194.2 billion in 1985, and $147.7 billion in 1986.(17) The deficit experience for Great Britain has already been noted.(18)

Part, and some liberal critics would argue a very large part, of the reason for these huge deficits can be traced to Reagan and Thatcher's plans to increase dramatically military spending over the next several years. In the United States:

> Real military spending is expected to grow 9 percent annually between 1981 and 1987. Over that period, military spending will rise from 5.6 to 7.8 percent of GNP, and from 25 percent to 37 percent of total federal spending.(19)

In Great Britain, the Thatcher government's plans call for a real, annual 3 percent increase in defense spending for the period 1981-82 to 1984-85.(20) Both leaders concede that such high levels of defense spending will impair their efforts to strengthen their respective economies.(21)

Although not expressly avowed, supply-side theory subscribes to the percolator theory of economic growth, that is resources should be allocated to those individuals and firms who will produce new goods and services. The lucrative returns of economic growth will then "percolate" or "trickle" downward to workers and consumers. In a revealing interview, David Stockman, President Reagan's director of the Office of Management and Budget, offered his view that supply-side economic theory was merely "trickle" down economics renamed.(22)

Yet if the necessary steps to revive private enterprise are to be taken, government must ensure that adequate amounts of capital investment in the appropriate industries are available. These steps necessarily call for a closer relationship between government and business. In the United States, President Reagan insists that "the most appropriate role for government economic policy is to provide a stable and unfettered environ-

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TABLE 4

Budgetary Growth in Great Britain and the United States 1975-1982

	Great Britain (1980 Survey Prices) Pounds in Millions	United States (1972 Constant Dollars) Dollars in Billions
1975	81,283	260.2
1976	79,202	274.3
1977	74,375	280.6
1978	77,951	293.8
1979	77,776	297.2
1980	79,245	316.7
1981	79,225	327.5
1982	77,800 (est.)	338.7

SOURCES: *The Government's Expenditures Plans,* Total Public Expenditure by Programme, Command 8175 (Session 1980-81), and Command 8494 (Session 1981-82).
The United States Budget in Brief, Fiscal Year 1984, Composition of Budget Outlays in Current and Constant Prices.

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ment in which private individuals can confidently plan and make appropriate decisions."(23) In Britain, Sir Geoffrey Howe, Thatcher's Chancellor of the Exchequer, envisions a more positive role for government. He declares that the "paramount aim of this Budget is to help industry, to encourage business, and to create jobs."(24) Despite these differences, both Reagan and Thatcher see a multi-pronged effort as essential to the revitalization of the private sector.(25) Both leaders recognize the necessity of a governmental role in economic recovery and both view supply-side policies as the most appropriate set of policies.(26)

In formulating revitalization efforts, the advocates of supply-side disclose a conservative conviction about how wealth (economic growth) is produced and who produces it. At its core supply-side theory takes for granted an elitist theory of economic growth. The great entrepreneurs of the late 19th and early 20th centuries provide ample historical evidence to confirm the supply-side point of view. Given this perception of the structure of economic growth and who is most likely to foster growth, it comes as no surprise that supply-side economics also recasts the role of the public sector in the management of economic affairs. Supply-side advocates argue that a reduced role for government is essential to increase the efficiency of market forces.

More significantly, a diminished role for the public sector will reverse the oppressive burdens government intervention places on human freedom. Milton Friedman speaks eloquently of the harm resulting from government intervention:

> We have gone very far in the past fifty years in expanding the role of government in the economy. That intervention has been costly in economic terms. The limitations imposed on our economic freedom threaten to bring two centuries of economic progress to an end. Intervention has also been costly in political terms. It has greatly limited our human freedom.(27)

Friedman's sentiments have been warmly subscribed to by President Reagan's closest economic advisers. In the *Economic Report of the President, 1982,* formulated by the Council of Economic Advisers, it is averred that:

> Political freedom and economic freedom are closely related....No nation in which the government has the dominant economic role has maintained broad political free-

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> dom; economic conditions in such countries are generally inferior to those in comparable nations with a predominantly market economy.(28)

This view of the role of government in the modern economy is, of course, contrary to the view held by Keynesians.

The ideological constraints of supply-side theory make it unlikely that government efforts to revitalize the economy of either nation will extend to micro-economic policies as opposed to macro-economic policies. Although some economists insist that micro-economic policies are better suited to achieve the desired results, the supply-side vision of a diminished role for government is inconsistent with the governmental intrusion required for tailoring micro-economic policies for such undertakings as capital investment.

Simply put, the supply-side position is that only a diminished role for government makes possible the efficient operation of the economic laws of the market. Supply-side economics invoke Adam Smith to reinforce their argument that the economic laws of the market operate most effectively when government intervention in the economy is minimized.(29) By limiting government interference in economic affairs, market forces are permitted to function more freely and efficiently in fixing prices over a greater range of goods and services. The market mechanism will also allocate wage patterns more effectively than governmental rules can. When market forces are allowed to operate competition between and among individuals and firms is enhanced.

For supply-siders one of the most important market forces is the money supply. Both the Reagan administration and the Thatcher government view restraints on monetary growth as essential to curbing inflation and to establishing monetary rules or targets. Such rules or targets help to ensure a stable investment climate and thus aid economic expansion.(30) Given Britain's somewhat greater emphasis on monetary policy, monetary targets are stated more explicitly.(31) Indeed, the Prime Minister insists that the "major innovation" in the British Budget in recent years is her plan that outlines a "progressive reduction in monetary growth over a period of years."(32) Although outside the President's immediate control, the Federal Reserve System's monetary policies are, according to the Council of Economic Advisers, essentially in accord with the President's view.(33) Monetary restraint is essential, supply-

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siders urge, because it permits economic laws to function most efficiently.

Economic laws are "naturally" superior to the "artificial" policies of public sector decision makers. Moreover, such economic laws function in a far less arbitrary manner than do the economic policies of governments. From a supply-side perspective, economic laws are neutral and do not result in the "unnatural" allocations of economic resources that the distributional policies of Keynesian economics produce. The very nature of governmental economic policy is such that government policy always endeavors to offset the functioning of economic laws and their results by establishing rules and regulations that modify the allocation of rewards that would flow from the unhindered operation of market forces.

From this discussion it should be clear that the economic policies of the proponents of supply-side economics are bound to differ markedly in form and content from the demand management policies of Keynesians. Yet, it is not the differences in economic policies between these two schools of thought that are most crucial. It is a triad of assumptions that are deeply conservative – an elitist theory of economic growth, a limited role for government in restoring an economy to health, and a belief in the "natural" superiority of economic laws and market forces as the most efficient allocators of resources – that is most crucial to a comprehension of the economic policies advocated by supply-siders. This triad shapes not only the foundation but also the specifics of supply-side economic policy. On this bedrock of conservative convictions, Reagan and Thatcher have built their economic policies. Given these underlying premises, it is not surprising that, as this paper has shown, American and British economic policies are remarkably similar.

The similarities in the economic policies are all the more striking when certain significant differences – institutional frameworks, size of the economies, differing degrees of economic interdependence – between the two nations are noted. Although Britain has a parliamentary system with responsible parties and unified control of its monetary system and America has a presidential system with decentralized parties and a fragmented control of its monetary system, Thatcher and Reagan have demonstrated that a decisive reversal in economic policy from Keynesian demand management measures to supply-side

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measures can take place under quite different institutional settings.

Nor has the size of the respective economies distorted the similarities in economic policies. If Gross National Product (GNP) figures are used, the American economy is more than six times larger than the British economy. Despite this difference in size, both leaders are urging monetary and fiscal restraint, tax reductions, the revitalization of the private sector, and increased defense spending. Closely related to differences in size is the differing degrees of interdependence of the two economies. Foreign trade accounts for 29% of British GNP while it accounts for only 9% of American GNP.(34) Although Britain is more vulnerable to world economic conditions, such vulnerability has not led Thatcher to modify the essentials of her economic recovery program. The triad of assumptions of supply-side economics that underpins the economic policies in both nations ensures that differences in policy are more likely to be the consequence of non-economic rather than economic factors.

Conclusions

In the limited scope of this paper, it was not possible to examine the impact of the economic policies of the Reagan administration and the Thatcher government in any detail. Inflation rates have declined significantly, but unemployment persists at double digit levels in both nations. No long term trends with regard to productivity are as yet discernible. Even with these indicators great care must be taken to establish a causal link (if possible) between changes in these indicators and supply-side economic policies. Econometricians have found this to be an extremely nettlesome task.

The problem is compounded by the fact that British economic advisers claim that a period of at least 3 to 6 years is necessary before Thatcher's policies will begin to reverse the present decline and produce positive developments. In his Budget Statement the chancellor affirmed that "reversing this decline would require a major effort, an effort that would need to be sustained over the lifetime of more than one parliament."(35) Thatcher's electoral victory in the June 1983 parliamentary elections assures her that her policies will be sustained for the requisite time period.(36) If this same claim is extended to the U.S. the short-run effects of Reagan's policies will not

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be apparent for nearly a year. Obviously, more time must pass before the supply-side policies of either leader are given a complete test. Keynesians have been quick to insist that such policies will not produce the intended results. Supply-side advocates, of course maintain that the beneficial effects of their policies have already begun to appear in the decline in the inflation rate. Other positive effects will appear if the respective governments adhere to their policies.

The Thatcher government has reiterated on several occasions its determination to pursue virtually unchanged the prime minister's plans for economic recovery. Despite strong pressure from within her own party, Margaret Thatcher's budgets have reflected this determination.(37) Much the same is true of Ronald Reagan. The mixed signals of the 1982 congressional elections, double digit unemployment, and a painfully slow recovery from recession, have not deterred the president. His campaign slogan for 1982 was "Stay the course!" and, as indicated by his fiscal 1984 budget, he appears determined to do so.

Yet given some of the limitations of supply-side economic measures, it is apparent that they will not supplant entirely countercyclical Keynesian economic policies in either America or Britain. Keynesian economic measures have proven themselves as an appropriate response to recessions that are the result of business cycle fluctuations. Despite the post-war expansion, supply-siders argue that Keynesian economic policies are not as adaptable to improving long term economic growth while preserving price stability as supply-side measures. The supply-side argument is very basic: in the post-war era all the conditions for sustained economic advance were present. It was merely a historical accident that Keynesians held governmental office. If supply-siders had been in power, growth would have been even more robust.

Reagan and Thatcher are now giving supply-side theory its chance to prove itself. The economic policies of both leaders rest on the supply-side vision of how the economy works and what is necessary to restore the economy to full health. If these policies succeed America and Britain will perhaps be able to challenge Germany and Japan for economic primacy. If they do not, both nations will continue to be subject to uncertain trends in the inflation rate, agonizingly high unemployment, and slow growth in productivity that hampers overall economic growth.

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FOOTNOTES

(1) I should like to thank Professor Roy Gregory of the Department of Politics, of the University of Reading, and Professor Barry Weller of the Department of Economics, The Pennsylvania State University, The Behrend College, for their assistance in the preparation of this paper. The assistance they rendered both in terms of data and insights made my task much easier.

(2) Quoted in A. Tylecote, *The Causes of the Present Inflation* (New York: Macmillan, 1981), p. 119.

(3) See the appropriate tables in the *Employment Gazette* (Great Britain) and the *Survey of Current Business* (United States) for details.

(4) For cross-national statistics on productivity growth, see: International Monetary Fund, *International Financial Statistics,* 35(5): 174-77 (Germany), 236-39 (Japan), 416-19 (United Kingdom), 420-25 (United States), 1982. Great care must be taken with productivity statistics because of the many difficulties in defining and measuring productivity. These difficulties are ably explored in: J.W. Kendrick and B.N. Vaccara, eds., *New Developments in Productivity Measurement and Analysis* (Chicago: University of Chicago Press, 1981).

(5) See Tables 1 and 2.

(6) For an analysis of the close ties between government and business in Japanese economic planning, see: J. Halliday, *A Political History of Japanese Capitalism* (New York: Pantheon Books, 1975).

(7) M. Olson in *The Logic of Collective Action* (Cambridge, Massachusetts: Harvard University Press, 1965) argues persuasively that rates of growth are more determined by retardants to growth than by stimulants to growth. Moreover, he maintains that established groups, both management and labor, are more likely to be growth retarding.

(8) L. Thurow, *The Zero-Sum Society* (New York: Basic Books, 1980), p. 22.

(9) *The United States Budget in Brief, Fiscal Year 1984* (Washington, D.C.: Government Printing Office, 1982), Budget Receipts and Outlays, 1789-1985, p. 84. Hereafter cited as *U.S. Budget 1984.*

(10) *Financial Statement and Budget Report, 1982-83,* Parliamentary Paper 237 (Session 1981-82), pp. 18, 22. Hereafter cited as *Financial Statement 1982-83.*

(11) Quoted in W. Grieder, "The Education of David Stockman," *The Atlantic Monthly,* December 1981, p. 51.

(12) "The New Economics: A Debate," *Economic Impact,* No. 35, 1981, p. 24. Arthur Laffer is the supply-side theorist with the greatest influence with the Reagan administration. A sample of his views can be found in: A.B. Laffer and B.C. Conley, "Interplay of Taxes, Output, and Fiscal Policy," *Tax Executive,* 30:336-338+ (July 1978), and A.B. Laffer and J.C. Turney, "Global Monetary Policy: Implications for the United States and Gold," *Journal of Social and Political Studies,* 5:3-38 (Spring/Summer 1980).

(13) "America's New Beginning: A Program for Economic Recovery," A White House Report, February 18, 1981, p. 14. Hereafter cited as "America's New Beginning."

(14) "Budget Statement," House of Commons Parliamentary Debates, *Weekly Hansard,* Vol. 19, Issue 1235, 5th March to 12th March, 1982, cols. 741-746, 754-755. Hereafter cited as "Budget Statement 1982-83," See also *Financial Statement 1982-83,* cited at note 10, pp. 5-11.

(15) *U.S. Budget 1984,* cited at note 9, p. 4.

(16) *Financial Statement 1982-83,* cited at note 10, p. 16.

(17) *U.S. Budget 1984,* cited at note 9, p. 84.

(18) See note 10 and the accompanying text.

(19) Council of Economic Advisers, *The Economic Report of the President, 1982* (Washington, D.C.: Government Printing Office, 1982), p. 85. Hereafter cited as *Economic Report 1982.*

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(20) *The Government's Expenditure Plans 1982-83 to 1984-85,* Command 8494 – I (Session 1981-82), p. 4. Hereafter cited as *The Government's Expenditure Plans 1982-83.*

(21) For the economic impact of defense spending, see: J.R. Capra, "The National Defense Budget and its Economic Effects," *Quarterly Review,* Federal Reserve Bank of New York, 6(2):21-31 (Summer 1981).

(22) Quoted in W. Grieder, "The Education of David Stockman," cited at note 11, pp. 46-47. Stockman's candid views in *The Atlantic Monthly* were also the subject of major stories in the November 23, 1982, issues of *Newsweek* and *Time.*

(23) "America's New Beginning," cited at note 13, p. 24.

(24) "Budget Statement 1982-83," cited at note 14, col. 756.

(25) The following sources should be consulted for the details of the multipronged effort to revitalize the economy. For Great Britain: "Budget Statement 1982-83," cited at note 14; *Financial Statement 1982-83,* cited at note 10; and *The Government's Expenditure Plans, 1982-83 to 1984-85,* Command 8494 – I and II (Session 1981-82), cited at note 20. For the United States: "America's New Beginning," cited at note 13; *The Economic Report of the President* (1982), cited at note 19; and "President Reagan's Program for Economic Recovery," The White House, April 1981.

(26) Several interesting issues in this regard are appraised in: A Protopapadakis, "Supply-Side Economics: What Chance for Success?," *Business Review,* Federal Reserve Bank of Philadelphia, May-June 1981, pp. 11-20.

(27) M.F. and R.F. Friedman, *Free to Choose* (Harmondsworth, England: Penguin Books Ltd., 1980), p. 88.

(28) *Economic Report 1982,* cited at note 19, p. 27. This report includes, in many places, an exposition of the assumption of supply-side economics.

(29) G. Gilder, *Wealth and Poverty* (New York: Basic Books, 1980), is a contemporary exegetes of Adam Smith's classic *Wealth of Nations.* See also Friedman, cited at note 27, pp. 48-54, for his analysis of Smith's understanding of the proper role of government.

(30) The arguments for monetary targets are examined in: *Monetary Targets and Inflation Control,* OECD Monetary Studies, (Washington, D.C.: OECD, 1979).

(31) "Budget Statement 1982-83" cited at note 14, col. 733, where the chancellor specifies a "target range of 8 to 12 percent."

(32) *Financial Statement and Budget Report, 1981-82,* Parliamentary Paper 197 (Session 1980-81), p. 22. Hereafter cited as *Financial Statement 1981-82.*

(33) *Economic Report 1982,* cited at note 19, pp. 63-64.

(34) World Bank, *World Development Report, 1981* (New York: Oxford University Press, 1982), Table 5, Structure of Demand, pp. 142-43. The figures are for 1979.

(35) "Budget Statement 1982-83," cited at note 14, col. 727.

(36) British economic policy prior to Thatcher has been analyzed in: R.E. Caves and L.B. Krause, eds., *Britain's Economic Performance* (Washington, D.C.: Brookings, 1980), and M. Steward, *Politics and Economic Policy in the United Kingdom since 1964* (Oxford: Pergamon Press, 1978).

(37) *Financial Statement 1981-82,* cited at note 32, p. 16. See also the almost identical policy position found in the budget for the previous and following years.

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INTELLIGENCE AND NATIONAL ACHIEVEMENT

Editor
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THE DEBATE OVER PAROLE IN THE UNITED STATES CRIMINAL JUSTICE SYSTEM

By Walter G. Thompson

In the year 1976, 60,000 felons were released from prison in the United States of America as parolees. That same year the United States legal code was amended to the effect that parole became a right, rather than a privilege, for all eligible prisoners. While removing the words "the Parole Board may in its discretion authorize the release of a prisoner on parole (if) there is a reasonable probability that such prisoner will live and remain at liberty without violating the law" (18 USC 4203 a), PL 94-233 required that a prisoner eligible for parole "shall be released" if "that release would not depreciate the seriousness of his offense or promote disrespect for the law; and that release would not jeopardize the public welfare."

Despite the apparent confidence of Congress in the efficacy of parole, as reflected by the 1976 legislation, criticism of the parole system had already been mounting during the preceding years, and the new Parole Commission guidelines of 1973, designed to make the system less arbitrary, had failed to satisfy these critics. Because of this critical attitude towards parole, the Council of State Governments reported in March 1980 that 27 states had introduced some form of mandatory sentencing while another 14 had introduced determinate sentencing, effectively reducing, if not abolishing, the authority of parole boards to determine the length of prison sentences. In Kannensohn's words, "Legislatures in many states are very unhappy with parole boards, which they see as arbitrary, capricious decision-makers."

Criticism of the parole system centers around three major arguments:

(1) That parole does not work in that it neither rehabilitates felons nor protects society.

(2) That the parole system cannot be made to work.

(3) That the parole system infringes upon the rights of both the public and the prisoners in that it fails to adhere to the normal principles of due process.

Parole Does Not Work

Statistics show that the percentage of parolees who commit

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new crimes or violate parole (recidivists) remains unacceptably high despite all efforts to ensure that parole boards are supposed to release only "good risk" prisoners.

Recidivism

While it has been suggested that the actual rate of recidivism was much lower than the 80% estimated by Bereiochea, Himelson & Miller (1972) for the President's Commission, it has also been claimed that the 41% figure given by the Comptroller General to Congress on October 12, 1977, is unduly low. The Comptroller General felt that his figures warranted the view that "the estimated 4,526 offenders (parolees and probationers) who had difficulty raises a serious question about the Federal Probation System's ability to help offenders adjust back into the community," but Hoffman, Stone-Meiehoffer & Barbar(1) argue that studies such as that upon which the Comptroller General based his figures give misleadingly low rates of recidivism and even greater reason for concern. They argue that such studies are only based upon recidivism which occurs before a parolee is returned to prison or discharged, without taking into account crimes committed after that person has completed parole – a period which averages approximately two years. Hoffman et al. commented on studies by Gottfredson & Ballard (1965), which surveyed the records of California parolees over a period of eight years after their release from prison, noting that there was a decreasing but substantial crime rate amounting to an 85% rate of recidivism over the first five years after release (25% in the first year, 10% in the fifth). Similarly they commented on studies by Kitchener, Schmidt & Glaser (1977), who found a 66% recidivism rate during the first four years following release, among 936 federal parolees. They also referred to studies by Bennet & Ziegler (1975),(2) who report a 58% rate of recidivism over three years. Gavin (1970)(3) notes a 59.5% rate of recidivism for Massachusetts over four years and an analysis of FBI Computer Criminal Histories of parolees over six years states that 62.5% committed crimes that were detected over that period.

(1) Journal of Criminal Justice Vol. 7 Fall 1979:193ff.
(2) Uniform Parole Report 1968.
(3) Uniform Parole Report 1970.

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Parole Recidivism Rates Differ Little from Discharged Ex-convict Recidivism

Studies by Gottfredson (1977), Hudson (1972), University of Southern California (1975) and the California Civil Addict Program (McGlothlin, Anglin & Wilson 1976) suggest that parolees achieve only slightly lower rates of recidivism than discharged ex-convicts. In the California Department of Correction Research Report no. 60, Starr describes studies comparing the rates of recidivism of regular and 'summary' parolees. A summary parolee is one who is only contacted twice, once at his release and once at discharge. Her study compared the records of 300 summary parolees with those of 300 regular parolees, one year after their release. Summary parolees had slightly but not significantly lower rates of recidivism.

Unsolved Crimes

Petersilia (1978)(4) examined the criminal careers of 49 habitual burglars. Noting that national statistics show that only 20% of all major crimes result in arrests, her statistics confirm these figures. 10,500 crimes seem to have been carried out by these 49 criminals, over 20 years – 20 crimes per year in those ten years during which each criminal was "on the street." On the average all these felons admitted that they reverted to crime four to five months after their first release from juvenile incarceration, or that they reverted to crime two to three months after their first adult incarceration, even though 50% claimed to have developed, serious intentions "not to return to crime". They were convicted in 54% of cases after arrest as juveniles and 78% of cases after arrest as adults, and were incarcerated in 39% of juvenile cases and 71% of adult cases. The records of their past cases were only filed against them in 40% of the cases and very rarely were they given 'habitual' offender status. Their average time of sentence was 2.4 years in the first incarceration, 3.3 years in the second and 3.0, 3.7 and 5;7 years in subsequent cases.

Conclusion

The well documented high rates of recidivism make it clear that parolees are not 'rehabilitated' by parole, and that their

(4) National Institute of Law Enforcement and Criminal Justice, 1978.

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release might instead be said to jeopardize public safety, especially in light of the high proportion of unsolved crimes committed each year.

Can Parole Ever Work

The Parole system was originally designed to carry out two functions:

(1) to authorize the parole board to release prisoners when they might benefit most from parole, and

(2) to provide a supervisory system which would facilitate the rehabilitation of the criminal.

Parole board selection of parolees: Parole boards select parolees on the basis of their past records, their current behavior in prison, and the impressions gained in a short interview with the potential parolee.

Salient Factor Guidelines: In 1973 the U.S. Board of Parole responded to pressure generated by Davis (Discretionary Justice 1971) and other critics to make parole decisions more consistent by laying down guidelines. In the months of August to November 1974, 80% of parole boards were reported to be following these guidelines (Stanley 1976), which were based upon studies clearly showing that recidivists were more likely to have a history of previous incarcerations, be younger, unmarried, and have a history of drug or alcoholic problems. A system of 'Salient Factor Scores' was drawn up according to which the length of time before parole depended upon a combination of present crime seriousness, inmate behavior and the above mentioned factors as recorded in the prisoners' record. Hoffman, Stone-Meiehoffer & Beck (1974, 1976, 1977) developed four 'risk' groups among parolees based on "Salient Factor Scores," predicting that in the first three years after release 'bad risk' parolees would have a violation rate of 50% (1st year), 31% (2nd year), and 23% (3rd year), while 'good risk' parolees would reveal rates of only 28%, 20% and 13% recidivism, respectively. The Parole Board was to sort out the "good risk" from the "bad risk" parolees.

The continual failure of the parole boards to properly discern 'good' and 'bad' risk parolees has substantiated the views of those who argue a) that inmate behavior cannot indicate parole success; or b) that parolee recidivism cannot be adequately forecast from a short interview.

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Inmate behavior: Himelson & Tageki administered tests in California in 1963 and 1965, from which they concluded that knowledge of the attitudes and roles of inmates in prisons did not increase the predictability of parole outcome. After Hoffman (1968)(5) reported that there was no statistical difference between the rates or recidivism of inmates who had received disciplinary punishments and those who had not, California aborted the need for participation in rehabilitation programs as a criterion for release on parole from prison.

Parole Board Interviews: In her examination of Habitual Felons, Petersilia discerned two types of habitual felons, the intensive and intermittent, both recidivists yet each totally different in character: the intensive felon committed ten times as many crimes and yet was five times less likely to be caught. The great variety of personal characteristics, compared with the short interviews and consultation time in which parole board members were expected to sum up prisoners, made Kozol, Boucher & Garafalo (1972)(6) and Glaser, Kenifarck & O'Leary (1968)(7) strongly suggest that parole board members who think they can identify which prisoners will be dangerous persons in the future are mistaken. Gottfredson, Wilkins & Hoffman (NCCD)(8) argued that "evidence that interviews are useful in parole predicting...has been preponderantly negative; repeatedly, comparisons have shown statistical prediction devices are more valid...Interview judgements disagree notoriously with one another and have little to do with parole outcome." The parole board interview is criticized on two major grounds: a) The Citizen's Inquiry on Parole and Criminal Justice (1975:49) determined that New York parole interviews vary from 4 to 25 minutes, averaging 6.12 minutes. During that time the prisoner's case must be examined – generally by only one of a panel of three – an interview must take place, and a decision be made. Many writers have questioned the ability of anyone to sum up a prisoner's chances of parole success in that time. b) Fortune Society, a New York based group in support of ex-convicts, argued(9) "Parole hearings are a kind of game

(5) National Council on Crime & Delinquency Research Report No. 8 February 1972:21.

(6) Crime & Delinquency 18 October 1972:371; see also Wenk, Roninson & Smith C&D 18 October 1972:393.

(7) Violent Offender HEW 1968.

(8) NCCD 1972 Research Center Report No. 5:8.

(9) *Wall Street Journal* July 13, 1979, p. 1, col. 1.

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prisoners play. You don't know what they expect you to do, so you play at being rehabilitated." As Stanley put it (Brookings Inst. 1976), "the more confident, experienced, convicts handled them easily: 'I've learned my lesson, sir. Nothing like that will ever happen again, sir!'"

The Inability of the Parole Program to Rehabilitate the Criminal or Protect Society

Ardent supporters of parole argue that the system would still have potential if parole officers had smaller-case loads, the parole boards were more flexible, and greater emphasis was placed upon rehabilitation programs. These areas call for examination:

Parole supervision: The Comptroller General's report to(10) Congress on October 21, 1977 reported that parole officers are overworked and only 14% of a parole officer's time is spent in face to face contact with each parolee. The Federal Judicial Center's report of February 26, 1973 had previously stated that only 8.5% of a parole officer's time was spent in such a manner. Despite attempts to increase personal contact the time spent by parolee officers in court and working on case paperwork could not be significantly reduced. Additionally, Takagi (1967), Hood & Sparks (1970), Robinson & Smith (1971), Neithercutt & Gottfredson (1973 Admin. Off. of US Courts) and Carter, Glaser & Nelson (February 1973) all conclude from tests that smaller case-sizes for overworked parole officers made no significant difference to rates of recidivism. Waller (1974) summarizes similar findings: "Supervision may make life more comfortable for the parolee, and may help him with personal problems, but this does not seem to have much bearing upon recidivism rates, except, perhaps, where the parolee's problem (e.g. alcoholism) is one that can lead to recidivism unless it is solved."

Parole Board Flexibility

The Comptroller General's report to Congress on October 21, 1977, examined claims that the parole commission is so hesitant in issuing warrants for the revocation of parole when requested by parole officers that the delays may be the cause

(10) Information from the Administrative Office of US Courts, US Parole Commission & Bureau of Prisons.

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of an increase in criminal convictions and parole officer slackness. In an examination of 283 random cases at revocation hearings, out of a total of 595 in the months September to December 1975, 228 were based upon convictions and only 55 on technical violations, offering support to these claims. Although the average time of warrant issue was 64 days, the Commission seems justified in delaying the issue of warrants for those already arrested. However, a report to the Department of Justice by the Federal Judicial Center (December 1979) noted the general reluctance of the Parole Board to issue warrants, giving the average time until warrant issue as 10 days after the last request to the parole officer by the board for further information. The Parole Commission answered that they would not "rush in with a warrant" without awaiting further report of the parole officer's alternatives to revocation.

Rehabilitation

In his report to Congress the Comptroller General (October 21, 1977) noted that 62% of 10,000 1973/4 parole cases were identified as having special problems: mental problems, low intelligence and scholastic achievement, alcoholism, drug addiction, etc. He reported that referrals were only made in 28% of these cases in 1973, but when questioned, parole officers replied that in 33% of these cases resistance to rehabilitation programs came from the offender himself. The Comptroller General argued that rehabilitation would have greater success if more emphasis were placed upon rehabilitatory programs.

Notwithstanding the obvious and accepted desirability of rehabilitation, belief in rehabilitation as a tangible, primary objective for most convicted criminals has declined as a result of studies that strongly suggest that curing recidivism is more dependent upon the attitudes of the prisoners than the availability of programs. Robinson & Smith (1971) concluded that variation in penal treatment only had a slight relation to outcome, Irwin & Cressey (1962) argued that inmate culture was imported by inmates, not caused by the institution, and Glaser (1964) suggested that inmates do not on the whole have planned meetings with ex-convicts after prison but continue the 'aloof' attitude found in prison. Such studies as these are supported by surveys of prisoners by Waller (1974), Starr(10) and Pownal(11). Waller found that 45% of prisoners claimed to

(11) California Department of Correction Research Report No. 60.

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believe that rehabilitation had to come from within the individual, 57% that rehabilitation programs and efforts were useless, and another 21% that it did not work on themselves. These figures may actually be artificially low because of a prisoner's natural desire to reflect a favorable attitude towards rehabilitation and, of course, shorter prison sentences. Starr found that 50% of these habitual prisoners did not even look for work after release, and Pownal made a detailed study of parolee employment problems. He discovered that 57% found jobs through family, friends or former employers before release — often as a condition of release (partially explaining low referral figures) — but they only kept their first job, on average, for four months (p. 149-155). 50% had never kept a job for a full year while during the first year following release, 19% had moved through 6 jobs or more as compared with only 17% who had remained at their first job. Pownal concluded (p. 218) that parolee employment and life-style seemed to be affected by deeply ingrained patterns of instability, while Sullivan (*Manpower* January 1971:6) suggested that "steady employment in a marginal occupation may tend to confirm an offender's view that there is no future in legitimate work and lead him back to crime": a vicious circle.(12)

Criticism of Parole Boards as Infringing Upon the Rights of Both the Public and Prisoners

Parole boards have been criticized in three different ways:

(1) Selection standards have been considered irregular.

(2) Parole board procedure has been considered very inconsistent between and within states.

(3) It is argued that parole boards carry out a judicial function without due process.

Method of Parole Board Selection

O'Leary & Nuffield (p. 23) carried out a study of parole system organization on behalf of the National Council on Crime and Delinquency, revealing that "24 jurisdictions [of the 54 in the country] have no statutory requirements for the appointment of parole board members responsible for the release of felony offenders. One state makes generalized references to character, twenty-one states refer broadly to experience or

(12) Employment Problems:155.

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training." The report continues "Many appointments have stemmed from political patronage, an especially dangerous criteria for positions which involve great discretion, human freedom in its most basic forms, and difficult moral, legal and scientific issues." However, Stanley (Brookings Institute 1976) did note that 40% of these jurisdictions require board members to be chosen by the chief executive of the state while 31 require confirmation by at least one house of the legislature. Terms of appointment range from those "at the pleasure of the governor" to "life," the majority being of 4 to 6 years in duration.

Inconsistency of Parole Board Procedure

In addition to the absence of adequate guidelines for the selection of Parole Board members, the system reveals wide discrepancies in average length of sentences, length of parole and parole time "credit" towards sentence length after revocation. To the extent that these discrepancies reflect different procedures in different states, this argument must be weighed against the constitutional right of states to pass their own legislation and set their own procedure with regard to criminal matters. As the Supreme Court ruled in *Greenholtz v. Inmates of Nebraska Penal & Correctional Complex 442 US 1* (May 29, 1979), states are free to administer parole systems as they choose and inmates are not entitled to the 14th Amendment in parole proceedings.

Sentence length: In its public report on the 1971 Attica, New York prisoner riots, the special investigating commission found that parole system incongruities contributed to tension and bitterness among prisoners. The following year(13) the chairman of New York State's Board of Parole, Regan, stated "There is no doubt about it. In the city of New York a man may get four years and for the same crime upstate he may get ten years." Northern Oklahoma's average sentence in 1973 was 44 months longer than that of Eastern Oklahoma, according to Zumwalt.(14)

Parole length: O'Leary (NCCD survey) found that in 13 states prisoners remained on parole till their maximum sentence was complete, in 6 there was a two year parole minimum, in 12 a one year minimum and in 13 there was no minimum length

(13) Oelsner *New York Times* September 27, 1972.

(14) Judicature Vol. 57 (October 1973), p. 97.

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of parole.

Parole as "credit' towards sentence time: O'Leary noted that in 29 states parole time until revocation was counted as credit towards a prisoner's maximum sentence, in 22 states it was not. In 13 states, parole revocation meant the loss of previous 'good time' credit, in 20 states the credit was not lost.

Due Process

Although Parole Boards note that parole is an 'act of grace,' and not a privilege, and argue that open board reviews jeopardize rehabilitation by allowing prisoners to obtain sensitive psychological reports concerning themselves, Boards have come under increasing criticism. Many critics like Bronstein of the American Civil Liberties Union (1974 "Rules for Playing God")(15) believe that "Openness would serve as a protection against arbitrariness, too, in the same way that the constitutional guarantee of a public trial is designed as a protection against judicial arbitrariness." Critics realize that parole decisions are based upon past history and the present sentence, and therefore argue that the role of the board in determining sentence length is the same as that of a judge, yet without due process: hearings are not open to public scrutiny, judgements are not subject to question, prisoners are not entitled to the 14th Amendment. Thus, when the New York State Commission reviewed its state parole system, it concluded, "Our belief is that sentencing is a judicial function, which shall be performed in a public forum – the courtroom – and open to public scrutiny."(16)

Answers to the Parole Problem

Recidivism rates and studies of parole release decision making have brought the parole system under serious criticism in all states and caused its effective abolition in many. Studies have undermined theories of rehabilitation and statistics have shown that the public is inadequately protected from the offender on parole. Since parole boards are unable to discern 'good risk' parolees with any reliability and mainly base their decisions upon facts present at sentencing, critics, like a recent Yale Law School Study, argue that(17) "[It] is difficult to see any

(15) Civil Liberties Review Vol. 1 (Summer 1974):120.
(16) Progressive December 1979 Vol. 43:18.
(17) Genego et al. 'Parole Release Decision-Making:893.

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purpose in having two independent decisions with respect to the same individual, based on the same data, aimed at achieving the same purpose...." In place of parole board sentencing, the Yale study (p. 893) and studies by the Commission for the Study of Incarceration (von Hirsh 1976:102), the Brookings Institute (Stanley 1976:80) and the Citizen Inquiry on Parole & Criminal Justice (Prison without Walls: 178) all support determinate sentencing with guidelines for each crime, "abolishing judge sentencing discretion" (Stanley 1976:80), and "choosing a period close to the median time actually served for the crime by offenders in recent years."

Conclusion

A perusal of the evidence clearly indicates that the parole system has failed, in that it neither contributes to the rehabilitation of criminals nor provides protection for society from paroled prisoners. Many who have studied it believe that it is inherently ineffective and therefore cannot be made to work, and that the only reasonable long term goal is the eventual nationwide abolition of the parole system – already limited or effectively abolished in a total of 41 states in the Union.

The main problem we face with the abolition of parole is the attempt to replace parole by judicial guidelines requiring unduly brief sentences to convicted criminals including those who already have ominous records, thereby reducing the period of protection which society receives when a criminal is incarcerated. The suggestion that guidelines should be determined on the basis of "the median time actually served for crime by offenders in recent years" is especially pernicious. At present, the unduly brief periods of incarceration which prevail under an ineffective parole system are considered an 'act of grace.' Under the system of determinate sentencing guidelines which has been suggested as a substitute, the evil effects of such brief periods of incarceration would be perpetuated as prisoners' 'rights.' Proposals favoring guidelines which require only brief sentences have generally been prompted by economic arguments which draw attention to the cost of the prison system, which as currently structured fails to utilize the work potential of the prisoners incarcerated at such expense. While regulations could be changed to require imprisoned criminals to contribute towards their upkeep by working regular and normal

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hours without financial reward, it should also be pointed out that the cost of maintaining criminals in prison is more than offset by the cost to society of the depredations of repeat offenders when not in prison, and that the cost of the apparatus for detecting crime, apprehending criminals and sentencing them can be even more costly – more inflationary – than the cost of prisons. It may also be mentioned that the suspension of the death penalty has in its own small way increased the economic burden on society in the case of murderers, who also – to the great misfortune of society – have been demonstrated to show a similar proclivity for recidivism when freed.

Accepting the view that a drastic tightening of, or total abolition of the parole system, must be considered, the question then arises as to how the goal can be achieved. As an essential first step we would recommend the opening of parole procedures to public scrutiny. Up to the present, researchers have been and still are denied access to parole board proceedings, and their information has been restricted to the statistical record of results. An open investigation, case by case, of the actual operations of the parole board, would place criminal scientists and legislators in a much better position to determine an appropriate alternative to the present almost totally pernicious parole system.

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ROGER PEARSON (Ed.)
Ecology and Evolution
The Institute for the Study of Man, Suite 520 1629 K St N.W. Washington D.C. 20006 ISBN 0-941694-00-3

A monograph written for the edification of political scientists, and comprising a sequential series of six articles by distinguished anthropologists and psychologists, *Ecology and Evolution* applies known facts relating to the origin and evolution of man, culture and society to the problems of social, moral and political philosophy. The relationship between environment and human biological and cultural evolution is clarified and the authors provide a clearcut appraisal of non-Marxist evolutionary views as to the evolutionary nature and physiological basis of human social relations.

In the first article, Roger Pearson discusses "Evolutionary Adaptation and Speciation" as processes governing all living organisms. Somewhat facetiously he argues that the only law of the universe which may be applied to human ethics is itself a truism: 'that which does not survive ceases to exist', he demonstrates the inevitability of evolutionary behavior and of the evolution of social systems among higher animals, and stresses the evolutionary requirement that moral systems *work*. This concept is further developed by F.J. Irsigler in the ensuing paper, entitled "Ecosystem and Genetic System".

Continuing from this point, J.W. Jamieson traces the roots of human social organization in "Mammalian Societies and the Emergence of the Family System", showing that familistic patterns of social organization far predate the evolution of *Homo sapiens*. The resultant implication is that pair-bonding may well be deeply built into the human psycho-physical mechanism.

Roger Pearson returns to take up and elaborate this argument in "Understanding Human Social Evolution: The Controversy between Kinship and Social Materialism", and compares the rival claims of Marxist "historical materialist" interpretations of the social process with those of biologically- and ecologically-oriented evolutionists, drawing particularly upon animal eth-

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ology for illustrative material. The amateurish guesswork of the political philosophers of the post-renaissance period – and earlier – has today been replaced by solid evidence concerning the evolution of human society from band to clan and tribe, and from thence to nation and state. Myopic concepts of economic determinism are revealed as inadequate to explain all the facets of human social behavior.

Finally, Raymond B. Cattell, Professor Emeritus of Research Psychology, University of Illinois, concludes this valuable collation with a chapter entitled "Ethics and the Social Sciences" in which he argues for an evolutionary-ecological basis for human social ethics and for the political systems which ultimately derive their validity from the accuracy of the ethical precepts in which they are rooted.

RANDOLPH H. BOEHM & DAN C. HELDMAN
Public Employees, Unions, and the Erosion of the Civic Trust
University Publications of America, Frederick, Maryland

Local and state governments are the fastest growing components of the public sector in America today, and public expenditures on wages comprise a major element in the large federal, state and local budgets that are threatening to destroy the total American economy. Unionization of public employees, resisted only by politically elected officials who seek to avoid union conflicts, has in many cases resulted in excessive wage demands being accepted by central, state and local government authorities. This book provides valuable case studies relating to local and state government/employee relations, and shows how in San Francisco, the Unions sought to gain control over the city's wages policy – an area which dominated 60% of the city's total budget – with the only check to their power being their own possible sense of restraint.

Viewing instances such as this, in a thoroughly documented survey, the authors must be credited with drawing attention to an issue which is of vital importance to America as a whole, and ultimately to the future of the world economy, dominated as it is by American economic prospects. There can clearly be no hope of controlling American budgetary deficits unless due attention is paid to the problem of organized government employees.

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Ethics and the Social Sciences
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